THE ENCYCLOPEDIA OF TAX PROCEDURES

LASSER

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THE ENCYCLOPEDIA
OF
TAX PROCEDURES

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TAX PROCEDURES

Edited by

J. K. LASSER

and

J. K. LASSER TAX INSTITUTE

Sydney Prerau, *Director*

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Preface

This book is designed to assist the lawyer, accountant, corporate fiscal officer, and other adviser on business or financial matters. To this group come the corporate officers, the businessmen, the investors, and ultimately all individual taxpayers. The increasing search for tax counsel is indicative of the growing awareness that the final measure of economic operation is the net after taxes.

The ambiguous certainty in many areas of the taxation process has been seriously affected by the 1954 legislation. New areas have been created by the Congress. Familiar areas have been extended, modified, or altered. All pose new problems that will spawn new cycles of judicial interpretation. The next years' activities of the Treasury and the courts will weave the pattern into which taxpayers must shape their transactions for maximum tax economy. For their tax advisers a critique by an authority of the continued old and a projection of the new can be a most invaluable tool.

To create such a tool, J. K. Lasser evolved a functional presentation and personally selected the specialists for the particular fields.

The functional presentation conforms with the usual manner in which a taxpayer is confronted with a tax situation. First comes the business transaction or other income-producing activity, then the tax implications. This is not to say, however, that the tax evaluation necessarily follows in point of time. As a matter of fact the prime value of the tax consultant is the possible or probable predetermination of tax consequences. In any event, this functional approach requires a full awareness of the tax effects of all aspects of a particular problem. And the tax adviser is necessarily required to tax-analyze the entire problem—a compartmentalized tax conclusion of but one phase of the activity is meaningless to the taxpayer.

In selecting the specialist for each field, Mr. Lasser covered the entire country. His selection of the particular one was grounded on his estimation of the experience, training, or other demonstration of the high level of excellence achieved by the specialist that would vouchsafe his ability to assist the tax adviser.

The Encyclopedia of Tax Procedures represents the last efforts of Mr. Lasser in his cherished occupation: the free and full discussion of income tax procedures. He loved to explore any and every phase of the law, making available without limitation the varied fruits of his diligent labors. It was in this spirit and with this motivation that the Encyclopedia was produced. In the development of this book as a practical tool for his tax colleagues he would have accomplished this objective.

We who have undertaken to carry on his work hope in all humility that he would have been pleased with our fulfillment of his plans. Our indebtedness to many is great—to all our contributors who ventured forth on uncharted seas in offering guideposts to a new law; to Irving Schreiber and Bernard Greisman, who supervised the editorial preparation of the articles; and to Suzanne Adel, who had the long and arduous task of supervising the host of editorial and publishing mechanics, which made this book possible.

Sydney Prerau
Director, J. K. Lasser
Tax Institute

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Part I

PLANNING AN ORGANIZATION AND OPERATION

UNIVERSITY EXTE

1

When a Business Body Will Be Taxed as a Corporation

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1. Points to Consider

In your tax practice, you have clients who (1) are either trustees or beneficiaries of trust property, (2) are members of a partnership, or (3) have an interest in a syndicate, a stock pool, or a joint venture. Under certain conditions, any of them may become subject to taxation as a corporation. What are the circumstances under which these various activities may become taxable? Concerning them, you will want to ascertain the answers to the following questions:

	Section
What is the statutory authority for taxing such bodies as corporations?	2
What kinds of business bodies come within the Statute?	3
What is a taxable association?	4
The tests of a taxable association	5

If you are particularly concerned with a trust, these points must be considered:

	Section
When is an ordinary trust not generally subject to tax?	6
When is a business trust subject to tax?	6
Tests for trust classification guiding principle of taxation	7
Tests for real property trusts	8
Trusts involving oil and gas properties	9
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If your client is a member of a partnership, the following questions are involved:

	Section
When will an ordinary simple partnership be taxed as a corporation?	13
How does the Service classify partnerships?	14
Limited partnerships and partnership associations	15

There are a great many other forms and kinds of business bodies that may also become subject to tax as corporations:

Section
General definitions of joint ventures, syndicates, pools, and simple associations 16
Joint ventures and syndicates in oil and gas properties 17
Joint operations and unit operations 18
Tenants in common and joint tenancies 19
The Internal Revenue Code of 1954 20

The law determining what business bodies are taxable as corporations is confusing and continually changing. There are hosts of conflicting rulings and decisions, due largely to the peculiar language in the successive revenue acts dealing with "an association taxable as a corporation." In order to escape confusion, many of the early rulings, decisions, and court cases have been eliminated from the body of this text, and every effort has been made to state only what is believed to be the present trend of the law on the subject. The earlier rulings and cases, which are necessary to understand the law in its present development, will be found in the footnotes.[1]

2. Statutory Authority for Taxing Associations

Unfortunately for taxpayers, there has never been a statutory definition of an "association taxable as a corporation."[2] All that the Code says is that, when used for income tax purposes and where not otherwise distinctly expressed or manifestly incompatible with its intent, "the term *corporation* includes associations, joint stock companies, and insurance companies."[3]

Bureau regulations and rulings attempt to construe the above language as imposing corporate tax liability upon all kinds of associations.[4] A study of the

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[1] For a more complete history of the development of the law on this subject, see the author's article, "What Constitutes an Association Taxable as a Corporation," *Proceedings of New York University Seventh Annual Institute on Federal Taxation,* page 1282. New York: Matthew Bender and Company, 1948.

[2] *Ibid.*

[3] 1954 IRC § 7701(a)(3); 1939 IRC § 3797(a)(3).

[4] Reg. 118, Sec. 39.3797-1, reads in part as follows:

"Classification of Taxables.—For the purpose of taxation the Internal Revenue Code makes its own classification and prescribes its own standards of classification. Local law is of no importance in this connection. Thus, a trust may be classed as a trust or as an association (and, therefore, as a corporation), depending upon its nature or its activities. (See section 39.3797-3.) The term 'partnership' is not limited to the common law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships. (See section 39.3797-4.) The term 'corporation' is not limited to the artificial entity usually known as a corporation, but includes also an association, a trust classed as an association because of its nature or its activities, a joint-stock company, an insurance company, and certain kinds of partnerships . . ."

Reg. 118, Sec. 39.3797-2, reads as follows:

"Association.—The term 'association' is not used in the Internal Revenue Code in any narrow or technical sense. It includes any organization, created for the transaction of designated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise. It includes a voluntary association, a joint-stock association or company, a 'business' trust, a 'Massachusetts' trust, a 'common law' trust, an interinsurance exchange operating through an attorney in fact, a partnership association, and any other type of organization (by whatever name known) which is not, within the meaning of the Code, a trust or an estate, or a partnership. An 'investment' trust of the type commonly known as a management legislative history of the above language found in Code Section 3797 indicates, however, that Congress did not intend to tax *all* associations as corporations, and this is the underlying hypothesis behind many of the court decisions.[5]

We are justified, therefore, in starting with the proposition that not all forms and kinds of associations are subject to tax as corporations. Just what kinds *are* taxable as corporations is the objective of this chapter.

3. What Kinds of Business Bodies Are Involved

The mere ownership and operation of property and the producing, transporting, and marketing of the articles of commerce have resulted in an endless variety of forms of business organizations, each differing in certain legal characteristics from the others. By and large, however, these many forms of organization can be put into six categories for income tax purposes. These are:

1. Sole proprietorships, the income from which is taxable to the individuals who own them.
2. Corporations, which are taxable as such.
3. Trusts, which are taxable either to the trustee or to the beneficiaries, depending upon the terms of the trust.
4. Partnerships, which make information returns of income earned, but are not taxable as such.
5. Joint ventures, syndicates, pools, and other like forms of associations, which are not taxable as such.
6. Associations, which are taxable as corporations.

The significance in such a classification lies in the fact that if any organization in the last four categories "follows the corporate line" for one or more of the reasons hereinafter discussed, it becomes, for Federal income tax purposes, a taxable entity and falls into the category of a corporation for tax purposes. Thus, an organization that a taxpayer may have created in the firm belief that it was a trust, a partnership, a joint venture, or some other kind of simple association, may be held to constitute an association taxable as a corporation under given circumstances.[6] The question is, what are those circumstances?

4. What Is a Taxable Association?

Guiding principle. In general, the courts hold that where two or more persons associate themselves for the carrying on of a common enterprise for profit, using the methods and forms analogous to a corporation, it will be subject to tax as a corporation.[7]

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trust is an association, and a trust of the type commonly known as a fixed investment trust is an association if there is power under the trust agreement to vary the investment of the certificate holders. See *Commissioner* v. *North American Bond Trust*, 122 F.(2d) 545, cert. denied 314 U.S. 701. If the conduct of the affairs of a corporation continues after the expiration of its charter, or the termination of its existence, it becomes an association."

[5] *Op. cit.*, footnote 1, above, at *Commissioner* v. *Gibbs-Preyer Trust* (6 Cir. 1941), 117 F. 2d 619, 26 AFTR 453. See also Smith, "Associations Classified as Corporations under I.R.C.," *California Law Review*, Vol. 34 (1946), page 461. There is a discussion of this precise point in Sears, *Trust Estates as Business Corporations*, 2nd edition, page 230 et seq., 1921.

[6] *See* Reg. 118, Sec. 39.3797-2.

[7] *Hecht* v. *Malley*, 265 U.S. 144, 4 AFTR 3976 (1924).

The Supreme Court later defined[8] what these methods and forms were, and laid down five "salient features" of corporate analogy:

1. The holding of title to the property embarked in the undertaking by, or in, the name of the group as an entity.
2. The opportunity for centralized management through operation by representatives of the group.
3. The power of the management as such to direct or control the operations, independent of individual owners or members.
4. The power to select successors so as to constitute a self-perpetuating body.
5. Limitations upon the personal or individual liability of members to the property embarked in the undertaking.

In later cases, the Supreme Court, after reviewing the *Morrissey* case, amplified this test somewhat by declaring that the word *association* implied associates, and hence that there must be associates engaged in some sort of business enterprise for profit in order to make the organization taxable.[9]

5. The "Tests" of a Taxable Association

It should be noted at this point that resemblance to a corporation in methods and forms of operation was originally the touchstone or test of taxability. This test originated with the celebrated tax case of *Hecht* v. *Malley*,[10] a case involving a Massachusetts Trust. Under Massachusetts decisions, if trustees were given full discretion to operate the trust properties, such associations were held to be pure trusts and taxed as such. If, however, the beneficiaries, who held certificates of interest, had the right to exercise any control over the operations, then the association was treated as a partnership, not subject to tax as a trust. The Supreme Court then held that, since the *Hecht* trustees exercised complete control over the trust operations similar to and resembling the methods and forms of a corporation, the term *association* must therefore include "such quasi-corporate organizations, under which they (the trustees) are engaged in carrying on business enterprises."

In later cases, hereinafter cited, the courts had difficulty applying the test of "corporate resemblance," largely because nearly all forms of business bodies have certain resemblances to the corporate form. The courts, therefore, turned to another test and said that the word association implies "associates," and if such associates are found to be engaged in a business enterprise, the group will be taxed as an association.[11] It is obvious, therefore, that there have been two tests of taxability, and the courts have applied one or the other, and sometimes both, in determining whether or not a particular business body was taxable. The rule that seems to be followed at present is stated by the District Court in *Davidson, Trustee* v. *U.S.*,[12] as follows:

> The nearest approach to a general test appears to be the requirement that in order to constitute an association, taxable as such, there must be a number of persons (asso-

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[8] *Morrissey et al., Trustees* v. *Commissioner*, 296 U.S. 344, 16 AFTR 1274 (1935).

[9] A. A. *Lewis & Co.* v. *Commissioner*, 301 U.S. 385, 19 AFTR 486 (1937); *Helvering* v. *Coleman-Gilbert Associates* (1 Cir. 1935), 76 F. 2d 191, 15 AFTR 411.

[10] Footnote 7, above.

[11] A. A. *Lewis & Co.* v. *Commissioner*, footnote 9, above.

[12] (D.C., Mich. 1938) 24 AFTR 1118; affirmed (6 Cir. 1940) 115 F. 2d 799, 25 AFTR 1073.

ciates) entering into a joint enterprise for the transaction of business. The courts have emphasized the general points of resemblance between all trusts and all corporations, not as holding that all trusts are associations, but as explaining the case with which the trust form can be used by associates in forming an enterprise for the transaction of business, and as justifying the subordination of form to substance in such cases.

6. When Will a Trust Be Taxed as a Corporation?

The Regulations plainly state that, for the purpose of taxation, the Internal Revenue Code makes its own classification of taxable entities and prescribes its own standards of classification. Section 29.3791-1 of Regulations 111 goes further and states that a trust may be classed as a trust or as an association taxable as a corporation, depending upon its nature or activities.

The Regulations[13] then proceed to distinguish between an *ordinary trust* and a *business trust*. An ordinary trust is one created by will or declaration of trust, under which the trustees take title to property of various kinds for the purpose of conserving it or protecting it, collecting whatever dividends or other income is derived therefrom, and distributing the same to the beneficiaries, who are neither the creators of the trust nor undertake any activities not necessary to conserve the trust property.

A business trust, on the other hand, is one where the property is conveyed to trustees for the purpose of investment—operating or using it as an enterprise with a view to earning income or profits for the beneficiaries.

To a substantial degree, the courts have followed this general classification and have held that trusts falling into the first class are not to be taxed as associations, but only as true trusts. Trusts falling into the second class have generally been held to constitute business associations, and hence taxable in the same manner as corporations. Although such a division of trusts into those two categories may be helpful in our thinking, it is of course in those cases where the trusts fall into neither of these classes, or where they have characteristics common to both classes, that the problems arise. In the tabulation that follows, the cases have been analyzed in respect of their primary purpose, the nature of their activities, and the extent of the powers and duties of the trustees, in an effort to detect the rationale of those decisions.

Kind of Property	Purpose	Activities	Powers and Duties of Trustee	Classification
Vacant land	Improve and operate for profit	Acquire land; build apartments; sales and rentals	Hold title; issue participating certificates; manage, sell, operate, distribute profits	Taxable association[14]
Office building	Operate or sublease	Collect rents for beneficiaries on commission	Hold title; issue fractional certificates; operate and distribute rents	Taxable association[15]

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[13] Reg. 118, Sec. 39.3797-3.

[14] *Swanson et al., Trustees* v. *Commissioner,* 296 U.S. 362, 16 AFTR 1268 (1935).

[15] *Title Ins. & Tr. Co.* v. *Commissioner* (9 Cir. 1938), 100 F. 2d 482, 22 AFTR 132.

Kind of Property	Purpose	Activities	Powers and Duties of Trustee	Classification
Oil properties	Develop and operate	Make leases; store, transport, and sell oil	Hold, lease, sublease and sell the properties. Sell oil, distribute proceeds	Taxable association[16]
Oil leases	Finance and drill oil wells	Drill and operate oil wells and sell products	Hold all property and all rights; manage, operate, and distribute proceeds	Taxable association[17]
Royalties	Pool oil royalties for joint benefit	Collect royalties and account for profits	Store, process, and sell oil and gas; make contracts and engage in other activities	Taxable association[18]
Tracts of agricultural land	Liquidate mixed interests	Lease, farm, and sell for final liquidation	Hold titles; execute leases; make sales; collect rents and royalties	Trust[19]
Oil and gas leases	Sell fractional interests and develop properties	Drill and develop, and sell oil	Take title; operate as common agent without control by various owners; account for proceeds	Trust[20]
Improved and unimproved real estate	Liquidate decedent's estate	Operate and gradually sell over long period	Take title; operate, lease, and dispose of properties; account to beneficiaries for rents and proceeds	Trust[21]
City properties and stores	Own and operate family estate	Manage and maintain properties	Hold titles; conserve, operate; distribute rents; make sales if directed by beneficiaries	Trust[22]
Timber lands and lumber mills	Liquidate corporation	Actively operate lands and mills over period of 7 years	Hold title and power to operate or liquidate in trustee's discretion	Taxable association[23]

7. Tests of Tax Classification—Trusts in General

Guiding principle. In attempting to classify any trust as taxable or nontaxable as a corporation, the controlling feature is the purpose for which the trust was formed. Regulations 111, Sec. 29.3797-3, not only so states, but also declares that:

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[16] *U.S.* v. *Trust No. B.1.35* (9 Cir. 1939), 107 F. 2d 22, 23 AFTR 850. Rev. Rul. 54-84, 1954 I.R.B. No. 11 holds that partnership may exist when title to oil and gas properties is in one person or group developing properties, if arrangement does not provide for continuity of life and centralization of management.

[17] *Helvering* v. *Coombs et al., Trustees,* 296 U.S. 365, 16 AFTR 1272 (1935).

[18] *Kettleman Hills Royalty Syndicate No. 1* v. *Commissioner* (9 Cir. 1940), 116 F. 2d 382, 26 AFTR 139.

[19] *Helvering* v. *Washburn* (8 Cir. 1938), 99 F. 2d 478, 21 AFTR 1140.

[20] C. A. *Everts et al.* (Jamison Lease Synd.), 38 B.T.A. 1039 (1938).

[21] *Wilson Trust,* 20 B.T.A. 549 (1930); *see also Paine et al. Exers.* v. *United States* (D.C. Mass. 1940), 32 F. Supp. 672, 25 AFTR 112, and cases cited therein.

[22] *Commissioner* v. *Gibbs-Preyer Trust,* footnote 5, above.

[23] *J. W. Wells Lumber Co. Trust A,* 44 B.T.A. 551 (1941).

> The nature and purpose of a cooperative undertaking will differentiate it from an ordinary trust. The purpose will not be considered narrower than that which is formally set forth in the instrument under which the activities of the trust are conducted.

One of the tests of a taxable trust, as prescribed by the Regulations, is whether an undertaking or management is conducted for income or profit, the capital or property being supplied by the beneficiaries and the trustees being, in effect, the managers of the undertaking, regardless of who appoints or controls them. In such a case, the beneficiaries will be treated as voluntarily joining or cooperating with each other just as the members of an association, and they will be taxable as such.

There are, of course, other tests of taxability, which must be considered along with the purpose. The following are some of the tests you can expect to be applied in that connection.

8. Trusts of Real Property

The test of taxability of trusts involving real property does not depend primarily upon the kind of property it happens to be, but rather upon the nature of the trust arrangement and the relationship of the trustee to the trust property. Where a trust is created for the purpose of taking title to either improved or unimproved land, with authority given the trustee to improve, lease, sell, or exchange for other property, paying the income to the creators of the trust as beneficiaries, a taxable association is formed.[24] The Supreme Court went further and said that, although the trustees failed to exercise all the powers given them in the trust instrument, they were nevertheless engaged in carrying on a business for profit, in much the same manner as the directors of a corporation are associated together in a business undertaking. It is also clear that the limited number of persons benefiting from such a trust is immaterial, and that a few persons as well as many may form an association for their common profit.

Generally speaking, the decisions seem to hold that if, under the terms of the trust, the duties of the trustee are largely ministerial and consist primarily of the mere act of holding title to property in order to accomplish some specified legal objective (such as to hold title to a building for the benefit of a partnership) no taxable association will result.[25] Again, if a real estate trust is organized to hold land for a period of time as an investment or to anticipate an appreciation in value,[26] or is designed primarily to conserve such property to prevent its dissipation or loss under a program of extensive borrowing,[27] it will probably be held not taxable as an association.

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[24] *Helvering* v. *Coleman-Gilbert Associates,* 296 U.S. 369, 16 AFTR 1270 (1935).

[25] *Southern Pile Fabric Co. Bldg. Trust,* par. 44,390 Prentice-Hall Memorandum T.C. (1944). But compare in this connection *Kingkade Hotel Co.* v. *Jones* (D.C. Okla. 1939), 30 F. Supp. 508, 24 AFTR 185, and *Cooperative Power Plant,* 41 B.T.A. 1143 (1940).

[26] *Pieroni Bldg. Trust et al.,* 45 B.T.A. 157 (1941).

[27] *Myers* v. *Commissioner* (7 Cir. 1937), 89 F. 2d 86, 19 AFTR 260. In *Main-Hammond Land Trust et al.* v. *Commissioner* (6 Cir. 1952), 200 F. 2d 308; 42 AFTR 958, where a trust was created for the purpose of taking title to land and operating it at a profit for benefit of certificate owners, it was held to be a taxable association even though the initial operation was to be by a lessee of the properties.

Real estate trusts formed primarily to avoid the dividing up of property between heirs, tenants in common, or other joint owners, so as to prevent its sale or dissipation, have been almost uniformly held to be true trusts, and not taxable associations.[28]

A trust created by a group of heirs of real property whose only purpose was to provide an effective agency for leasing the property over a period of time and collecting and disbursing the rents was held to be not taxable as an association.[29] This sort of doctrine has been upheld by various courts in a number of cases, even where the trustee was given other powers and duties that were deemed to be incidental to the trustee's primary functions.[30]

On the other hand, the courts have been equally inclined to hold otherwise in cases where the relationship of the trustee to the trust property has been that of an entrepreneur, and his functions have consisted not only in acquiring and holding title to real property, but have been coupled with the power to develop,[31] improve,[32] operate as rental properties,[33] or to lease or sell an office building at a profit to the organizers of the trust.[34] There are a great many cases in support of this doctrine.[35]

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[28] *Magoon Trust Estate et al.*, par. 42,406 Prentice-Hall Memorandum B.T.A. (1942).

[29] *Wyman Building Trusts*, 45 B.T.A. 155 (1941).

[30] Other cases involving real property where the trusts were held not taxable as an association are:

State National Bank of El Paso, Texas, trustee (Pecos County Trust Estate) (D.C., Texas, 1944) 55 F. Supp. 457, 32 AFTR 853 (trust providing for collection and distribution of income derived from specific tracts of land, to designated beneficiaries).

Sears v. *Hassett* (D.C., Mass. 1942) 45 F. Supp. 772, 29 AFTR 1113 (trust holding one parcel of real estate, which had been leased for a 50-year term; activities confined to receipt and disbursement of income and trustees' powers so limited).

Meyer Krom et al., par. 42,416 Prentice-Hall Memorandum B.T.A. (1942) (trust created to hold property previously acquired by family members—properties handled substantially as before—no formal meetings of trustees, by-laws, nor resolutions).

Hugh MacRae Land Trust, 1 T.C. 899 (1943), dismissed (4 Cir. 1944) (trust created to execute lease on a trust of coal deposit land and pay royalties to a group of beneficial owners).

Arthur Jordon Foundation, par. 53,042 Prentice-Hall Memorandum T.C. (1953) (a trust created to take over a going business previously carried on by two corporations, but whose primary purpose was to devote all profits to charitable purposes, was held not to constitute a taxable association).

[31] *Commissioner* v. *Highlands etc. Subdivision* (7 Cir. 1938), 88 F. 2d 355, 19 AFTR 131.

[32] *Joseph E. Swanson*, 29 B.T.A. 1123 (1934), affirmed (7 Cir. 1936) 80 F. 2d 1021, 17 AFTR 177.

[33] Footnote 24, above.

[34] Footnote 15, above.

[35] Other cases involving real property where the trusts were held to be taxable as a corporation are:

Trust No. 5833, Security-First National Bank of Los Angeles v. *Welch* (9 Cir. 1931), 54 F. 2d 323, 10 AFTR 901, cert. den. 4-18-32, affirming (D.C. S.D. Calif. 1931) 50 F. 2d 613, 10 AFTR 56.

Merchants Trust Co., Trustees v. *Welch* (9 Cir. 1932), 59 F. 2d 630, 11 AFTR 556.

St. Louis Hills Syndicate Fund, et al., 36 B.T.A. 575 (1937), affirmed (8 Cir. 1939) 102 F. 2d 1013, 22 AFTR 997.

J. H. Porter, et al., Trustees, 42 B.T.A. 681 (1940), affirmed (9 Cir. 1942) 130 F. 2d 276, 29 AFTR 1144 (NA, 1943-15-11497).

Sibley Syndicates, par. 41,334 Prentice-Hall Memorandum B.T.A. (1941), affirmed (6 Cir. 1942) 131 F. 2d 224, 30 AFTR 261, cert. den. 4-12-43.

One of the best statements of the close distinctions that must be drawn in cases of real property trusts is found in the opinion of the Board of Tax Appeals in *Pieroni Building Trust*,[36] where it was said:

> This trust was not intended "to provide a medium for the conduct of a business and sharing its gains." Cf. *Morrissey* v. *Commissioner*, 296 U.S. 344; *Mortgage Trust Certificate Pool*, 42 B.T.A. 1238. It was not to carry on any business of its own or to make profits for the holders of beneficial interests. Its purpose was merely to serve the convenience of the partnership by holding the real estate and receiving only enough rent to pay its expenses and meet the obligation of the mortgage. Cf. *Kingkade Hotel Co.* v. *Jones*, 30 Fed. Supp. 508; appeal dismissed, 108 Fed. (2d) 1015; *Cooperative Power Plant*, 41 B.T.A. 1143. That is all it ever did and during these taxable years it was not an association taxable as a corporation. Cf. *Commissioner* v. *Gibbs-Preyer Trusts Nos. 1 and* 2, 117 Fed. (2d) 619, affirming 39 B.T.A. 492; *Lewis & Co.* v. *Commissioner*, 301 U.S. 385. This case is distinguishable from *Sears* v. *Hassett*, 111 Fed. (2d) 961, by the fact, already mentioned, that it was not "created as a joint enterprise for the carrying on of a business and sharing its gains" but was merely to hold and conserve a particular property, with incidental powers, as in the traditional type of trusts.

The Land Trust. One species of trust of real property that merits particular consideration is the so-called *land trust*, common in many of the eastern seaboard states and in certain states in the Midwest. It is, in general, a form of pure investment where income-producing real property is placed in trust, with legal title and full possessive rights vested in the trustee. Certificates of beneficial interest, sometimes called *land trust shares*, are sold to the public, each share representing a ratable interest in the properties. The land trust had its origins in the Massachusetts trust or business trust and usually preserved most of its characteristics as to limited personal liability and continuity of interest through the transferability of its shares.[37]

The Bureau of Internal Revenue attempted to tax the Massachusetts type or business trust in several cases,[38] but without success until the Supreme Court decided *Hecht* v. *Malley*[39] in 1924. In that case, the Court discarded completely the old test that it had previously applied: whether there was a sufficient measure of control left in the beneficiaries to distinguish such a trust from the centralized management of a corporation. The Court adopted the test of corporate resem-

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Lee H. Marshall Heirs, 39 B.T.A. 101 (1939), affirmed on this point (3 Cir. 1940) 111 F. 2d 935, 25 AFTR 7, cert. den. 10-14-40.

U.S. v. *Trust No. B.1.35, Bank of America Nat. Trust & Savings Association* (9 Cir. 1939), 107 F. 2d 22, 23 AFTR 850, reversing 25 F. Supp. 608, 22 AFTR 211 (the functions of the trustees with reference to collection, care, and disposal of oil produced from its leases constituted a business for profit, even though conducted through an agent).

Fletcher et al. (*The Standard Bentonite Co.*), v. *Clark* (D.C. Wyo. 1944), 57 F. Supp. 479, 32 AFTR 1554, affirmed (6 Cir. 1945) 150 F. 2d 239, 33 AFTR 1520, rehearing denied 11-19-45.

Joseph C. Grew, par. 48,153 Prentice-Hall Memorandum T.C. (1948); *Collector* (*Dan M. Nee*) v. *Main Street Bank, et al.* (8 Cir. 1949), 174 F. 2d 425, 37 AFTR 1464 (trusts buying and selling property).

[36] Footnote 26, above.

[37] "Massachusetts Trusts," *Yale Law Journal*, Vol. 37 (1917), page 1103. *See* discussion in *Senior* v. *Braden*, 295 U.S. 422 (1935).

[38] *Eliot* v. *Freeman*, 220 U.S. 178, 3 AFTR 2852 (1911); *Crocker* v. *Malley*, 249 U.S. 223, 3 AFTR 2998 (1919).

[39] *Hecht* v. *Malley*, footnote 7, above.

blance, saying that, in the case of a Massachusetts trust, the trustees were associated in the same manner as the directors of a corporation for the purpose of carrying on a business enterprise, and hence the trusts were held to be taxable associations.

As a result of the *Hecht* case and later decisions of the Supreme Court, changes and amendments appeared in many land trusts, designed primarily to eliminate the unnecessary and unused powers of the trustee as well as powers that indicated specific business purposes of the trust. In many cases, the trust instrument was designed to set up an ordinary or conventional type of trust, with only such powers as were incidental to such a relationship. Even so, the difficulty of applying the test of corporate resemblance to such trusts has continued, owing largely to the fact that the land trust is a widely variable form of organization that lends itself as an adjunct to many other forms of business organizations. The courts in such cases have endeavored to apply the principle that, as long as the parties remain co-owners of the trust property and restrict the operations of the property to those of joint tenants or tenants in common, it will retain its character as a trust; but when the parties "prefer to become associates and not to become partners," then a taxable association will result.[40]

9. Trusts Involving Oil and Gas Properties

In no area of business can be found a greater variety of so-called "associations" than in the oil and gas industry. This is owing primarily to the peculiar characteristics of oil and gas as fugacious minerals, as well as to the necessities of spreading the costs of development and operation of oil and gas leases over as wide a basis as possible. As a consequence, we find almost every conceivable kind of trust, syndicate, joint venture, and association has been employed, all with varying powers, functions, and obligations.

The leading case in this field is that of *Helvering* v. *Coombs, et al., Trustee.*[41] In that case, the trust was created by the owner of an oil and gas lease for the purpose of financing and drilling a well, selling the production, and distributing the proceeds to holders of certificates of beneficial interest, 13 persons being named as beneficiaries. The Supreme Court held that the trust authorized the trustee to manage the property, pay obligations, sell products, and distribute the net profits; that these were powers of business management and centralized operation similar to the management of a corporation; and that it was immaterial that the beneficiaries did not exercise their powers of control, held no meetings, and that only one property was involved. It will be noted that the Court based its decision largely on the fact that the trust provided for associates, to be joined in a business enterprise for profit, with centralized control, and with continuity for the term of the trust.

In line with the *Coombs* case, it has been generally held in numerous cases involving oil and gas properties that, wherever the trustee is vested with authority (1) to take possession of and explore for minerals, (2) to operate producing properties over a substantial period of time, (3) to renew, extend, or make new leases, and (4) to sell or dispose of production for the account of the beneficiaries, such an arrangement constitutes a taxable association.[42]

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[40] *Helvering* v. *Coleman-Gilbert Associates,* footnote 24, above. *See* the discussion of this topic in the "Notes" by Joseph Taubman, *Tax Law Review,* Vol. 8, Nov. 1952, pages 103-111.

[41] Footnote 17, above.

On the other hand, there are a number of cases where the owners of undivided interests in oil and gas properties created trusts, utilizing the services of the trustee simply as a common agent to develop and operate the properties under powers of attorney for limited periods of time. The courts have held that the trustee was acting in a restricted capacity as an agent for the individual owners, and that no taxable association was created.[43]

In the case of *Wabash Oil & Gas Association* v. *Commissioner*, decided in 1947,[44] the Circuit Court of Appeals for the First Circuit went back to the original doctrine of corporate resemblance; but it pointed out that the Federal courts have split on the issue, the Fifth Circuit holding the question of resemblance to be an issue of fact, and the Sixth and Ninth Circuits holding that it constitutes an issue of law only. In either case, the necessity of procuring positive evidence dealing with all the "salient features" of corporate resemblance seems obvious.

10. Family Trusts

As a general rule, trusts created for the purpose of insuring the preservation of family property, to keep an estate intact, to prevent its dissipation, or to insure a proper distribution of a decedent's estate to his beneficiaries will not be held to constitute taxable associations. In the leading case of *Guitar Trust Estate*,[45] the Court emphasized that the question was to determine as a fact what the primary purpose was for which the trust was organized, rather than the methods and forms of operation. The same principle is applicable whether the trust is created by will or *inter vivos*.

Thus, in *Blair* v. *Wilson Syndicate Trust*,[46] a trust created by a widow in order to insure an equitable division of her husband's estate, with full powers to hold, operate, or sell, constituted a trust and not a taxable association, even though it operated the properties, collected rents, and carried on all necessary activities to effectuate the trust. The ultimate purpose, said the Court, was orderly liquidation and not the carrying on of a business. The Tax Court applied the same rule in *Estate of Becker*[47] upon similar facts, and prescribed as the requisites of a taxable association:

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[42] There are numerous similar cases involving trusts of oil and gas properties. *Thrash Lease Trust*, 35 B.T.A. 444 (1937), affirmed (9 Cir. 1938) 99 F. 2d 925, 21 AFTR 1225, cert. den. 3-27-39; *Kettleman Hills Royalty Syndicate No. 1*, par. 40,041 Prentice-Hall Memorandum B.T.A. (1940), affirmed (9 Cir. 1940) 116 F. 2d 382, 26 AFTR 139; *Nashville Trust Co., Ex. (McCabe)* v. *Cotros* (6 Cir. 1941), 120 F. 2d 157, 27 AFTR 393, 122 F. 2d 326, 27 AFTR 847, cert. den. 11-10-41, reversing (D.C. Tenn. 1939), 26 AFTR 1230. The more recent cases are to the same effect. See *Helm & Smith Synd.* v. *Commissioner* (9 Cir. 1943), 136 F. 2d 440, 31 AFTR 177; *Henry, Lilly Lease*, par. 44,137 Prentice-Hall Memorandum T.C. (1944). *See also U.S.* v. *Trust No. B.1.35*, footnote 35, above.

[43] Footnote 20, above. *See also Commissioner* v. *Horseshoe Lease Syndicate* (5 Cir. 1940), 110 F. 2d 748, 24 AFTR 775, cert. den. 311 U.S. 666; *Commissioner* v. *Rector and Davidson* (5 Cir. 1940), 111 F. 2d 332, 24 AFTR 919. *See also Wabash Oil and Gas Association* v. *Commissioner* (1 Cir. 1947), 160 F. 2d 658, 35 AFTR 1018; *H. P. Robinson, et al.*, par. 45,357 Prentice-Hall Memorandum T.C. (1945).

[44] Footnote 43, above.

[45] *Commissioner* v. *Guitar Trust Estate* (5 Cir. 1934), 72 F. 2d 544, 14 AFTR 477. Later cases follow the *Guitar Trust* case in principle. *See Williams, Tyrrell & Meade Trustees*, par. 44,216 Prentice-Hall Memorandum T.C. (1944); *Estate of J. W. Neal*, 8 T.C. 245 (1947); *Trust of Frank 1931* v. *Commissioner* (3 Cir. 1948), 165 F. 2d 993, 32 AFTR 1478; *Cecelia K. Frank Trust*, 8 T.C. 375 (1947).

[46] (5 Cir. 1930), 39 F. 2d 43, 8 AFTR 10475. Later cases are reviewed in *Thomas R. Reyburn*, par. 46,642 Prentice-Hall Memorandum T.C. (1946).

(a) Associates in a plan or undertaking.
(b) A business purpose.
(c) A combination of characteristics resulting in a closer resemblance to a corporation than to a trust.

11. Trusts in Liquidation or Dissolution

Trusts created for the purpose of liquidating the assets of an estate, or partnership or jointly owned property, or corporate assets in dissolution, are generally held not to be taxable as associations.[48] The cases are uniform in holding that, where liquidation is contemplated as soon as the circumstances of the case permit and the interim operation of the business is incidental to the maintenance and preservation of the estate or business, no taxable association is created.[49]

On the other hand, where the trust, though created for the purpose of ultimate liquidation of partnership assets, is given authority to continue buying and selling at a profit and continues in that business for an indeterminate period of time, it will be held to be taxable as a corporation.[50]

In the case of *United States* v. *Hill, Trustee,*[51] the Tenth Circuit held that where part of the assets of a partnership are conveyed to a corporation, and the remainder is transferred to a trust with broad powers to employ and invest for the benefit of the corporation, the trust was not to be deemed as aiding in the liquidation of the partnership but as furthering the business of the corporation, and hence was taxable as an association.

Similarly, if a trust created ostensibly to liquidate a corporation is given broad and general powers to carry on the business for an unlimited time and actually continues its operations beyond the time reasonably necessary to wind up the business, it will be treated as a continuation of the corporation's business and taxable as such.[52]

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[47] Par. 43,311 Prentice-Hall Memorandum T.C. (1943).

[48] *See Davidson Trustee* v. *U.S.* (6 Cir. 1940), 115 F. 2d 799, 25 AFTR 1073, and cases there cited.

[49] *Helvering* v. *Washburn* (8 Cir. 1938), 99 F. 2d 478, 21 AFTR 1140; *Nee* v. *Linwood Securities Co., et al.* (8 Cir. 1949), 174 F. 2d 434, 37 AFTR 1473. In *Anna B. Negus, et al.*, par. 53,075 Prentice-Hall Memorandum T.C. (1953), a trust was created to take over the assets of a dissolved corporation and to carry on the business while the assets were being liquidated. It was held that it was a liquidating trust even though its operations were extensive, and not a taxable association.

[50] *U.S.* v. *Hill, Trustee* (10 Cir. 1944), 142 F. 2d 622, 32 AFTR 699. In *Martin Keatts, et al.* v. *U.S.* (D.C., W.D. Tenn. 1952), 1952 P.-H. par. 72,599, a trust under will of employer created for purchase of continuing decedent's business as joint enterprise by his employees was held to be an association taxable as corporation.

[51] Footnote 50, above.

[52] *J. W. Wells Lumber Co. Trust* A, 44 B.T.A. 551 (1941). In *Edgar Mercer Burleson*, par. 53,279 Prentice-Hall Memorandum T.C. (1953), a business that continued after corporate charter was revoked held taxable as corporation or association rather than as partnership.

12. Investment Trusts

Investment trusts of the so-called management type, where the trustees or managers are given broad powers to sell, purchase, and deal in securities for the account of the beneficiaries, are generally held to be taxable as corporations.[53] Investment trusts, even of the fixed or permanent investment type, are held to be taxable as corporations if there is power under the trust instrument to change or vary the investment of the certificate holders.[54]

For a full discussion of the subject of investment trusts and a review of the cases, see *Commissioner* v. *City National Bank and Trust Co.*,[55] where the Tenth Circuit defined the doctrine primarily as one of distinguishing between an "orthodox trust" and a "business trust." It held that where a trust was created to sell trust certificates and use the proceeds for investing in securities, there was the required "community of interest" among the beneficiaries sufficient to create a taxable association, regardless of the fact that the trustee failed to use many of the powers given him.

However, if the trustee or managers of the trust, though having managerial powers over the trust properties, are restricted as to sales solely for conservation of the trust estate, it is not taxable as a corporation.[56] Also, if the power of the trustee as to sales is limited to his discretion in weeding out undesirable securities and keeping his portfolio in sound investment condition, it is not taxable as a corporation.[57]

13. When Will a Partnership Be Taxed as a Corporation?

A partnership, as such, has never been considered to be a legal entity sufficiently distinct from its partners to become subject to a separate Federal income tax.[58] Neither is a joint venture, nor a syndicate, nor a group, nor a pool, nor any other simple association.[59] It is only when a partnership or association partakes of the nature of a corporation that it becomes subject to tax as such.

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[53] T.D. 5468, amending Reg. 111, Sec. 29.3797-2 (now Reg. 118, Sec. 39.3797-2); *Commissioner* v. *North American Bond Trust* (2 Cir. 1941), 122 F. 2d 545, 27 AFTR 892. Where investment trusts were organized under charter provisions giving the trustee or depositor the right to vary at will the existing investments of the certificate holders and thus to control the nature and extent of their investments, such trusts constitute taxable associations. On the other hand, where certain other trusts gave no powers to the trustee or depositor beyond those necessary to preserve the existing trust property, collection of income therefrom, and the distribution of net proceeds to the certificate holders, it was held that these constituted strict investment trusts which were not taxable associations. *See Royalty Participation Trust*, 20 T.C. 466 (1953).

[54] T.D. 5468, id.; *Commissioner* v. *City Bank, Trustee* (10 Cir. 1944), 142 F. 2d 771, 32 AFTR 737.

[55] Footnote 54, above.

[56] *Equitable Trust Co.* v. *Magruder* (D.C., Mo. 1941), 37 F. Supp. 711, 26 AFTR 853; I.T. 2583, X-2 C.B. 213.

[57] *Commissioner* v. *Buckley* (9 Cir. 1942), 128 F. 2d 124, 29 AFTR 473; *Equitable Trust Co.* v. *Magruder*, footnote 56, above.

[58] 1954 IRC § 701; 1939 IRC § 181; *City Bank Farmers Trust Co.* v. *U.S.* (1942), 97 Ct. Cl. 310, 47 F. Supp. 105, 30 AFTR 143.

[59] 1954 IRC § 7701(a)(2); 1939 IRC § 3797(a)(2); Reg. 118, Sec. 39.3797-4.

It is of interest to note that none of the so-called common-law tenancies, such as tenancy in common, joint tenancy, or tenancy by the entirety, have ever been considered by the courts to be partnerships. The Uniform Partnership Act, under Section 6, does not classify any of these tenancies as such. The Tax Court has held in at least two decisions that there are distinct legal differences, such as the manner in which the property is owned, and that these differences may well result in different tax consequences.[60]

The various revenue acts since 1932, however, after loosely treating taxable associations as corporations, dispose of the other types of associations, such as joint ventures, pools, and syndicates, by lumping them all together as partnerships—which, of course, they are not.[61] The problem is to unscramble these various kinds of joint ventures, syndicates, groups, pools, and so on, and in turn to distinguish them from taxable associations (corporations).

14. Partnerships Under Treasury Regulations

Treasury regulations make a very simple distinction between a partnership and a taxable association. If two or more persons buy land for purposes of subdividing and selling it at a profit, taking title in their joint names, they are deemed to have created a partnership and are taxable individually on their shares of partnership earnings.[62]

However, where two or more persons contribute money or property for the purpose of buying land, and if one or more of them or an agent for the group takes the money, purchases and takes charge of selling the land and operating the enterprise, the Bureau will treat it as an association, and tax it as such.

On the other hand, the courts generally have required more substantial proofs of corporate resemblance than the setting up of an agency with powers of operation of property. The courts have clearly recognized that two or more persons can set up a business enterprise for profit and can designate one or more of their members to operate it, provided they do not adopt methods of ownership and operation closely resembling a corporation.[63]

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[60] *See Jacob Larus,* par. 41,067 Prentice-Hall Memorandum B.T.A. (1941), affirmed (2 Cir. 1941) 123 F. 2d 254, 28 AFTR 297; *E. M. Godson,* par. 46,182 Prentice-Hall Memorandum T.C. (1946); *McInerney* v. *Commissioner* (6 Cir. 1936), 82 F. 2d 665, 17 AFTR 665.

[61] The classification found in 1954 Code Sec. 7701 (1939 IRC § 3797) was obviously made for administrative purposes, the preparation and handling of returns, etc. *J. F. Curtis,* 3 T.C. 648 (1944); *C. S. Osborn,* 22 B.T.A. 935 (1931); *H. S. Tuthill,* 22 B.T.A. 889 (1931). In *Roland P. Place* v. *Commissioner* (6 Cir. 1952), 199 F. 2d 373, 42 AFTR 701, affirming 17 T.C. 199 (1951), (A) 1951-2 C.B. 3, where taxpayer rented property from his wife and used it in a business which he individually owned, an increase in the rent measured by a percentage of the profits of the business did not constitute a reorganization of the business into a partnership nor did it constitute the wife a joint venturer with taxpayer in an association. The sharing of profits alone is not sufficient evidence of a partnership.

[62] Reg. 118, Sec. 39.3797

[63] *J. A. Riggs Tractor Co., et al.,* 6 T.C. 889 (1946); *F. S. Delp* 5 T.C. 1351 (1945). The distinction between a true partnership on the one hand and a joint venture, syndicate, pool, etc. on the other hand, can have considerable importance taxwise. Certain limitations on capital losses, which might apply in the case of partnerships, would not be applicable to taxpayers as joint tenants or as individuals. *See Johnston* v. *Commissioner* (2 Cir. 1936), 86 F. 2d 732, 18 AFTR 662; *Winmill* v. *Commissioner* (2 Cir. 1937), 93 F. 2d 494, 20 AFTR 566; *Estate of Appleby,* 41 B.T.A. 18 (1940). In *Haley et al.* v. *Commissioner* (5 Cir. 1953), 203 F. 2d

It is quite possible, for example, for a group of persons to enter into an agreement with an agent, giving him, through powers of attorney, the authority to purchase securities for their joint account, and dividing the proceeds of sale on a pro rata basis, without creating either a common-law partnership or a taxable association. For tax purposes, they will probably be treated as a partnership, but certainly no separate taxable entity has been created. This is the rationale of the case of *Winmill* v. *Commissioner*,[64] and it has been followed in a number of later decisions.[65] It is also the rule followed in *Commissioner* v. *Whitcomb Coco-Cola Syndicate of Ga.*[66]

Guiding principle. Generally speaking, a partnership whose affairs are carried on by the partners themselves and not by a centralized management, control being exercised in accordance with the respective interests of the partners, and whose continuity is terminated by the death or withdrawal of a member, will not be held to constitute a taxable association.[67]

There is a whole series of cases in which the courts have had before them the issue of partnership versus a sole proprietorship, and which must not be confused with the issue here.[68] Most of these cases have involved family partnerships, in which the sources of income have been contributed by one of the partners, with no ratable contribution in capital or services from other partners.

15. Limited Partnerships and Partnership Associations

There are two kinds of limited partnerships. In the first category, where shares of stock or certificates of participation with limited liability and negotiability are issued, the partnership continues in business regardless of the death or withdrawal of a partner, and the management is centralized in a board or committee acting for the various partners. In this case, a taxable association is generally held to result because the partnership has inherent traits of a corporation.[69]

Conversely, a limited partnership can be created that is lacking in all the above characteristics of a corporation except for a limitation on the personal liability of

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815, 43 AFTR 853, reversing 16 T.C. 1509, however, it was held that where an individual enters into an agreement with a corporation under which he borrowed funds from the corporation, which were used jointly with other funds of the corporation to carry on its business, an association taxable as a corporation was created rather than a partnership or sole proprietorship.

[64] Footnote 63, above.

[65] *See John C. Henderson*, par. 40,087 Prentice-Hall Memorandum B.T.A. (1940); *Spreckels* v. *Commissioner*, 315 U.S. 626, 28 AFTR 1010 (1942), and cases there cited.

[66] (5 Cir. 1938) 95 F. 2d 596, 20 AFTR 1140.

[67] *Jacob DeKorse*, 5 T.C. 94 (1945), affirmed (6 Cir. 1946) 158 F. 2d 801, 36 AFTR 24. Where a group of doctors created a "partnership" for the purpose of joint practice of medicine as a clinic, with Articles of Association placing the management of its business in the hands of a committee and providing for continuation of the association despite deaths or withdrawals, the U.S. District Court of Montana held it constituted an association taxable as a corporation. *See Kintner et al.* v. *U.S.* (D.C. Mont. 1952), 107 F. Supp. 976, 42 AFTR 810. Solicitor General authorized appeal to U.S.C.A. (9 Cir.).

[68] In the case of *Commissioner* v. *Tower*, 327 U.S. 280, 34 AFTR 799 (1946), and *Lusthaus* v. *Commissioner*, 327 U.S. 293, 34 AFTR 806 (1946), the Court held that no valid partnership had been created, in spite of written articles and agreements purporting to create one, and that all the income should be taxed to the person who contributed the sources of income. The Court did not raise the question as to whether or not a taxable association had been created.

[69] *Goll* v. *Kavanagh* (D.C. Mich. 1941), 29 AFTR 1362.

the partners. In such a case, the courts have held that it must be classified as a simple partnership, even though it may have other features of a corporation.[70]

The same principles of taxation apply to limited partnerships organized under the Uniform Limited Partnership Acts of the various states, as set forth previously in regard to limited partnerships in general. The laws of the various states and constructions of the state courts are, of course, not controlling of the Federal tax question.[71]

Partnership associations, which are referred to in many states as joint stock associations, constitute another class of partnerships that must be considered. A joint stock association or company usually combines the characteristics of a corporation with a limited partnership. It is an asssociation of persons for profit with a common capital, divided into negotiable shares. Its purpose is to carry on, on a more or less permanent basis, a business enterprise managed by elected or selected individuals called directors.[72]

Since such groups obviously partake of the nature of a corporation, both in their forms and methods of organization, they have been considered to be taxable as corporations since the Revenue Act of 1913.

16. Joint Ventures, Syndicates, Pools, and Other Forms of Simple Association

A *joint venture* is usually defined as an association of two or more persons, organized to carry out a single business enterprise for profit.[73] A *syndicate* is an association of a somewhat similar nature, but formed for some temporary purpose only, usually of a financial character.[74] A *pool* is defined as a combination of persons contributing joint capital for operation, investment, or speculation in some particular kind of property or commodity, with a view to making profit therefrom.[75]

Under the several revenue acts since the Revenue Act of 1932, all such forms of simple associations are classified as partnerships for ordinary income tax purposes, which means that the distributable income from such associations is taxable to the various participants as if they were partners.[76] However, where such associations partake more closely of the nature of a corporation than of a partnership, they will become subject to tax as corporations.[77] Since the Code places all joint ventures, syndicates, pools, and similar associations into the classification of partnerships, it becomes necessary to put the organization in question into the category of a partnership in order to keep it from being taxed as a corporation.

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[70] *Glensder Textile Co.,* 46 B.T.A. 176 (1942).

[71] *Davidson Trust* v. *U.S.* (D.C. Mich. 1939), 24 AFTR 1118, affirmed (6 Cir. 1940) 115 F. 2d 799, 25 AFTR 1073. Rev. Rul. 144, 1953-2 C.B. 212, provides that a mere change or shift of membership does not of itself terminate a partnership for income tax purposes and does not create a new partnership. By letter dated 2-12-54, signed by H. T. Swartz, Director, Tax Rulings Division, 1954 Prentice-Hall Tax Service, par. 76,585, it was held that it does not necessarily follow as a result of Rev. Rul. 144 that a limited partnership must be taxed as a corporation merely because its continuation depends upon the consent of the continuing partners.

[72] *In re Jones,* 59 N.Y.S. 983; *Adams Express Co.* v. *Scofield* (1901), 111 Ky. 832, 64 S.W. 903; *Jacob Frost, et al.,* 13 T.C. 307 (limited partnership association organized under special Ohio Code provisions held taxable as corporation).

[73] *I. A. Greenwood,* 22 B.T.A. 1187 (1931); *see* especially *Wild* v. *Commissioner* (2 Cir. 1933), 62 F. 2d 777, 11 AFTR 1376, and cases therein reviewed.

[74] *Nowland Realty Co.* v. *Commissioner* (7 Cir. 1931), 47 F. 2d 1018, 9 AFTR 1052; *Gates* v. *Megargel* (2 Cir. 1920), 266 Fed. 811; *McCausey* v. *Burnet* (C.C.A. D.C. 1931), 50 F. 2d 491, 10 AFTR 37.

[75] *Kilbourn* v. *Thompson* (1881), 103 U.S. 168; *Mollyneaux* v. *Wittenberg,* 58 N.W. (Neb.) 205 (1894).

Guiding principle. Although there are so many types of joint ventures, syndicates, and like associations that any generalization is difficult, the principal consideration in such cases is the relationship of the several participants to the properties involved. If their ownership is immediate, their management and control is direct, and their right of participation is analogous to a partnership's division of earnings, they will usually be classified as a partnership, and not as a taxable association.[78]

The courts have even gone so far as to hold that an individual may enter into an arrangement with a corporation, under which both parties agreed to pool their respective interests in oil and gas leases, erect a gasoline extraction plant, and process the gas from the pooled leases without creating a taxable association. In the *Landreth* case,[79] the Court held that the arrangement constituted a joint venture that was a "species of partnership," and that therefore the proprietary interest of each party therein was a capital asset, subject upon subsequent sale to capital gains treatment.

Real estate syndicates. Where a syndicate or association is organized for the purpose of buying, selling, holding, leasing, and dealing generally in real estate, providing for continuity of interest and centralized management, it will almost invariably be held taxable as a corporation.[80]

In many of the cases involving syndicates for the development and operation of real property, an organization was created that was considered to be a separate entity with transferable interests and with continuity of existence beyond the lifetimes of the original members.

Stock syndicates. The majority of stock syndicates are composed of individuals who contribute funds to a common fund and agency to buy, hold, sell, invest, or speculate in securities for a limited period, using the joint funds of all members to pay the costs, expenses, and losses of the undertaking, and dividing the proceeds, including any profits, among the members.[81] In most cases, the courts have held such groups not to constitute taxable associations, upon the grounds that a common agency rather than a separate entity was created, that the securities became the common property of the members, and that there was no continuity of interest contemplated.

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[76] In *Estate of Philip Landau,* 21 T.C. No. 79 (1954), appealed to 5 Cir. by taxpayer, a Pennsylvania bank mortgage pool was held to be a partnership of its participants rather than a trust or corporation.

[77] Loss deduction denied individual participating in venture held to be association taxable as corporation in *J. B. Wenger, et al.,* par. 54,024 Prentice-Hall Memorandum T.C. (1954).

[78] *Landreth* v. *U.S.* (D.C. Tex. 1946), 70 F. Supp. 991, 35 AFTR 1169; *Beryl Hillyard,* par. 42,584 Prentice-Hall Memorandum T.C. (1942).

[79] Footnote 78, above.

[80] *Royal Palm Syndicate, et al.,* 45 B.T.A. 138 (1941), dismissed 30 AFTR 1598. *See Fidelity Bankers Trust Co.,* 37 B.T.A. 142 (1938), for excellent opinion on the whole subject. Also *see Solomon* v. *Commissioner* (5 Cir. 1937), 89 F. 2d 569, 19 AFTR 404; *Tyrrell* v. *Commissioner* (5 Cir. 1937), 91 F. 2d 500, 19 AFTR 1129; *St. Louis Hills Syndicate* v. *Commissioner* (8 Cir. 1939), 102 F. 2d 1013, 22 AFTR 997. In each of these cases, the Court held that the creation of an "organization" operating separately and independently of its members was the controlling feature.

[81] *See* the discussion in *McCausey* v. *Burnet* (C.C.A. D.C. 1931), 50 F. 2d 491, 10 AFTR 37.

In these leading cases, the courts distinguished syndicates from corporations upon the following grounds:

1. The agreement created a nonrevocable agency in a common manager-agent for a limited time, but the property was owned in common by the members in their individual capacities. There was a joint adventure of the several members, rather than a separate entity.[82]

2. Where a syndicate was organized to deal in certain specified stocks for a limited period, with transferable participating interests, but with the right of termination reserved in the manager to exercise at any time, the syndicate was held to be a joint venture, and not an association.[83]

3. A syndicate organized for the sole purpose of marketing one stock, and thereafter to be dissolved, with no charter, no capital, no bank account, and no authority in the manager other than to sell the stock and account to the owners for the proceeds, is not a taxable association.[84]

4. An organization set up to dispose of certain stock, without authority to buy or deal in it, holding the stock in its name but with all the beneficial ownership in the several members, was held to constitute a joint agency rather than a taxable association.[85]

In the more recent case of *Reg Halladay,*[86] three syndicates were organized to deal in shares of Canadian mining companies through a board of managers, with limited liability of members, but no limit on the period of operations. The Board of Tax Appeals held that, since an organization had been created to carry on a business venture for profit through purchases and sales of securities, with ample authority to borrow money for such purposes, it constituted a distinct business enterprise separate from its members and was separately taxable as an association. The Board virtually ignored the test of corporate resemblance, basing its holding primarily upon the activities of the syndicate as a separate entity engaging in a business enterprise for purposes of profit.

17. Joint Ventures and Syndicates in Oil and Gas Properties

Out of the complexity of divided ownership and interest so prevalent in the oil and gas industry, numerous types of joint ownership and operation have developed.

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[82] *Commissioner* v. *Whitcomb Coca-Cola Syndicate* (5 Cir. 1938), 95 F. 2d 596, 20 AFTR 1140; *Harry B. Lake,* par. 40,152 Prentice-Hall Memorandum B.T.A. (1940); *Theodore Schulze & Co., Inc.,* par. 40,159 Prentice-Hall Memorandum B.T.A. (1940).

[83] *Pierre S. DuPont,* 37 B.T.A. 1198 (1938); *J. J. Raskob,* 37 B.T.A. 1283 (1938), affirmed (3 Cir. 1941) 118 F. 2d 544, 26 AFTR 746; *Harry B. Lake,* footnote 82, above.

[84] *Harry MacConaughey,* 41 B.T.A. 408 (1940); *Theodore Schulze & Co., Inc.,* footnote 82, above.

[85] *E. L. Cord, et al.,* 38 B.T.A. 1372 (1938); *Charles A. Kaufman,* par. 43,355 Prentice-Hall Memorandum T.C. (1943); *W. F. Enright,* par. 45, 377 Prentice-Hall Memorandum T.C. (1945).

[86] Par. 42,025 Prentice-Hall Memorandum B.T.A. (1942), affirmed (3 Cir. 1942) 131 F. 2d 435,30 AFTR 302. *See also Bert* v. *Helvering* (D.C. App. 1937), 92 F. 2d 491, 20 AFTR 271.

The commonest of these are two types of simple association usually designated in the industry as *syndicates* or *joint ventures.* In these two types, the owners, regardless of the varying nature of their mineral interests, agree upon a plan for the joint development and operation, upon a common agent, upon a division of expenses, and upon a method of proportionate division of the proceeds.[87]

The courts have held in numerous cases, as we have already seen in our discussion under Section 9 of this chapter, that trusts created to finance, develop, and operate oil and gas properties, sell the products, and distribute the net profits to the beneficiaries are taxable as corporations. The test of taxability in those cases was usually based on the purpose for which the trust was created.[88]

It seems clear from early regulations and rulings of the Bureau of Internal Revenue that certain types of jointly owned and operated oil properties were treated as simple nontaxable associations, to be distinguished for purposes of taxation from both partnerships and corporations. Article 1507 of Regulations 45 and Article 1507 of Regulations 62 provided that:

> Joint investment in and ownership of real and personal property not used in the operation of any trade or business and not covered by any partnership agreement does not constitute a partnership. Co-owners of oil lands engaged in the joint enterprise of developing the property through a common agent are not necessarily partners. In the absence of special facts affirmatively showing an association or partnership, where a vessel is owned by several individuals and operated by a managing owner or agent for the account of all, the relation does not constitute either a joint-stock association or a partnership. The participation of two United States corporations in a joint enterprise or adventure does not constitute them partners.

Guiding principle. The primary test, however, in the case of oil and gas syndicates and joint ventures, seems to turn on whether the organization in question more nearly resembles a partnership than it does a corporation. If the syndicate or joint venture sets up a relationship between the participants that is in the nature of tenants in common, acting through the operator of the property as a common agent for each participant, without provision for continuity or limited liability, it will not generally be taxable as a corporation.[89]

The Tax Court has not hesitated to hold in a series of Memorandum Opinions that, even in a case where it is clear that a joint business enterprise is entered into for profit, and even where a centralized management is employed to carry on the business, no taxable association results where the properties remain in the name of the several owners, the income is earned in their names, and the owners remained individually responsible for all expenses of development, operation, and sale of the production.[90] The same sort of conclusion was reached in the case of the joint operation of farm properties, the Tax Court laying stress on the fact that a joint tenancy in real property had been created, since either party might have maintained an action for partition. Such was the holding in the *Horace P. Robinson* case.[91]

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[87] For a discussion of the nature of such agreements, *see Commissioner* v. *Rector and Davidson* (5 Cir. 1940), 111 F. 2d 332, 24 AFTR 919.

[88] *See Helvering* v. *Coombs, et al. Trustees,* 296 U.S. 365, 16 AFTR 1272 (1935), and numerous other cases cited above.

[89] *See Commissioner* v. *Horseshoe Lease Syndicate* (5 Cir. 1940), 110 F. 2d 748, 24 AFTR 775, cert. den. 311 U.S. 666, for a full discussion of the cases; C. A. *Everts, et al.,* 38 B.T.A. 1039 (1938); *T. A. Johnston,* 38 B.T.A. 1199 (1938); *Fortney Oil Co.,* par. 40,032 Prentice-Hall Memorandum B.T.A. (1940).

[90] *See W. F. Enright,* footnote 85, above, for a vigorous opinion on the subject. As to the joint operation of farm properties in much the same manner, and stressing the angle of common-law tenancy in common, *see Horace P. Robinson, et al.,* par. 45,357 Prentice-Hall Memorandum T.C. (1945).

In each of the following cases, the taxpayer was held to be a nontaxable joint venture or syndicate, distinguished from a corporation upon the grounds indicated:

1. Under a joint power of attorney, various individuals authorized the attorney either (1) to sell their respective part interests in oil and gas leases, or (2) to make contracts for their joint development and operation. The attorney had no authority to operate the properties himself, could act only in the "name, place and stead" of the owners, and was limited to collection of proceeds and distribution to the respective owners.[92]
2. Where the taxpayers, as tenants in common of undivided interests in oil and gas leases, made contracts with agents for their joint development and management, keeping title in themselves and limiting the powers of the agents to the contractual obligation to develop and operate, with no attempt to limit the owner's separate liability, no taxable association was created.[93]
3. A joint undertaking entered into by all the owners of a lease, reserving all titles and ownership in the individual members, with no limitation upon their individual liability for all acts of the common agent, created a joint venture in the nature of a mining partnership, rather than a taxable association.[94]
4. Where the several owners of undivided interests in oil and gas leases made a contract with an oil company for the development of the property for the joint account of all working-interest owners, paid all expenses, and charged each owner with his share, and title remained with the various owners, the enterprise was held to be a joint venture, not taxable as an association.[95]
5. Where a joint venture was organized by various lease owners to hold the leases, collect the income and royalties, and distribute proceeds to the participants, there was no taxable association.[96]

18. Joint Operations and Unit Operations

The operation of oil and gas properties for the account of other persons or groups is an inherent part of the business and is prevalent throughout the industry in many forms. The two outstanding types of such joint operation are known as "joint accounts" and "unit operations."

Joint accounts comprise those situations in which the property, usually a single lease, is operated by one of the working interest owners for himself and all other owners of mineral interests, including royalties, paying all expenses of operation and accounting to the other participants for their shares either in kind, or for the proceeds thereof.[97]

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[91] Footnote 90, above.
[92] *Henry Lilly Lease,* par. 44,137 Prentice-Hall Memorandum T.C. (1944).
[93] *Hanover, et al.,* par. 45,287 Prentice-Hall Memorandum T.C. (1945).
[94] *W. F. Enright,* footnote 85, above.
[95] *Commissioner* v. *Happold* (5 Cir. 1944), 141 F. 2d 199, 32 AFTR 271.
[96] *Buckeye Oil Joint Adventure,* par. 41,209 Prentice-Hall Memorandum B.T.A. (1941).
[97] *Reynolds* v. *McMurray* (10 Cir. 1932), 60 F. 2d 843, 11 AFTR 840.

It is again of some significance to note that for many years the Bureau of Internal Revenue, following the court decisions in the southwestern states, issued rulings holding that jointly operated oil properties were distinguishable from partnerships, and no suggestion that such enterprises might be classified as taxable associations appeared in those rulings. In 1934, the Bureau issued I.T. 2749,[98] clearly stating its position in the following language:

> In the instant case the co-ownerships of the oil and gas leases and the operations thereunder may be fairly considered as falling within the broad scope of the term "joint venture." While the term "joint venture" is usually, but not necessarily, limited to a single transaction, it has been held that the business of conducting such a venture to a successful termination may continue for a number of years (*Hobart-Lee Tire Co. v. Goodsky,* 46 S.W. (2d), 859). It is true that ordinarily joint or co-ownership of property does not of itself constitute a partnership but it is also true that when the co-owners or joint owners agree to employ such property in the carrying on of a trade or business they become partners (47 C.J., 702).

By way of contrast, a unit operation consists in the creation of an agreement whereby all the mineral-interest owners in an entire field or producing zone agree to carry on the exploration, development, and operation under a single plan, whereby one of the owners is designated as operator to act as the agent for each of the various interest owners. The powers and duties of the operator are described in the agreement and are limited to the confines of the one operation. There is no authority to bind the individual owners other than as specified under the unit agreement. An operating committee is usually created, composed of representatives of the various interest owners. It is given authority to supervise the operations, but the authority of each representative is limited to representation of his principal only, with no power to represent or bind other interest owners.

Very few cases have been decided by the courts dealing with the taxability of joint or unit operations as corporations.[99] Bureau regulations and rulings were even more meager up to the latter part of 1948, and consisted mainly of two rulings issued in 1934, which held, on general principles, that where the several co-owners of oil and gas leases undertake the development and operation thereof at their joint expense, paid for monthly by each in accordance with its respective interest, and sharing likewise in the proceeds from the property, a joint venture is created, and the various participants are treated for tax purposes as partners.[100]

On November 29, 1948, I.T. 3930[101] was issued, purporting to modify I.T. 2749 and I.T. 2785.[102] Early in 1949, two additional rulings to clarify I.T. 3930 were issued.[103]

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[98] XIII-1 C.B. 99.

[99] Cf. *Wabash Oil & Gas Ass'n.,* 6 T.C. 542 (1946); *Burk-Waggoner Oil Association v. Hopkins,* 269 U.S. 110, 5 AFTR 5663 (1925); *G. E. Jordan, Trustee,* 28 B.T.A. 372 (1933). In each of these cases the question involved was one of a joint stock association, rather than a true "joint operation" as that term is used in the oil industry. *See also* the discussion of these and other cases in the article by J. Q. Weatherly, "Operating and Unitization Agreements and the Income Tax Consequences from Such Operations," *First Annual Institute on Oil and Gas Law and Taxation of Southwestern Legal Foundation,* pages 519-543. New York: Matthew Bender & Company, 1949.

[100] I.T. 2749, XIII-1 C.B. 99; I.T. 2785, XIII-1 C.B. 96.

[101] 1948-2 C.B. 126.

[102] Footnote 100, above.

[103] I.T. 3933, 1948-2 C.B. 130; I.T. 3948, 1949-1 C.B. 161.

In these several rulings, the Service made an obvious attempt to get away from the confusing and overlapping doctrine of "corporate resemblances," as well as the very difficult rule based on "associates" joining in a business enterprise for profit. After analyzing the cases, the Service concluded that in almost any type of jointly operated business there will be found associates, continuity of existence, some form of centralized management or control, and, if it is a business enterprise, a joint profit motive. The Service then proceeded to hold that, since the first three of these "tests" was in *all* joint enterprises, the joint profit motive must be the controlling one.

The ruling then went on to hold that, in cases where the parties have designated an operator and vested in him an "irrevocable representative capacity," with power to develop and operate the properties and to sell or dispose of the products for the account of the various owners, such an arrangement renders the group taxable as an association.

In the later ruling, I.T. 3948,[104] the Service clarified I.T. 3930 by stating that the test of "irrevocable representative capacity" would not apply in cases where the operator of the properties or an outsider acquires from the respective owners the option to purchase the share of oil or gas owned by each. It was also ruled that the test would not apply in cases where the operator was (for example) given revocable authority to sell or dispose of the shares of the respective owners, provided the period of time given for such authority was limited to such reasonable periods of time as were consistent with the demands of the oil and gas industry under the circumstances, but in no event to exceed one year.

As a result of these various rulings, the tax status of joint operations or unitized operations of oil and gas properties will hereafter be considered in the light of the rules that follow.

Guiding principle. Wherever a joint or unit operation creates an organization in the nature of a mining partnership (which is one that can arise only between joint owners), which extends to and is terminated by exhaustion of the mineral deposit, in which the majority in interest controls policies, and in which the death or withdrawal of a participant does not interrupt the relation, it will not be held taxable as a corporation.

Applying this principle to the various types of joint operations and unit operations common in the oil and gas industry, the Internal Revenue Service classified them into two categories, as follows:

1. Where the operating agreement or unit agreement reserves the right of each participant to its share of the oil or gas in place—or the equivalent thereof, which is the right to sell its share, direct the sale thereof, or authorize the operator to sell it for the time being for the account of such participant—a partnership is created in which the participants own depletable economic interests in the oil and gas in place and must report the proceeds therefrom as their income.

2. On the other hand, where the operating agreement or unit agreement creates an organization in which some person or group is irrevocably authorized in a representative capacity to extract and sell the minerals produced for the joint account of two or more of the co-owners, this constitutes an association with a joint profit

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[104] Footnote 103, above.

objective, which is taxable as a corporation. In such cases, the association is deemed to be the owner of the depletable economic interest in the oil and gas in place and of the income derived from the operation.[105]

19. Tenants in Common and Joint Tenancies

The majority of cases involving both tenants in common and joint tenancies arise in connection with family inheritance or ownership of real property. The courts have held repeatedly that the ownership of property as joint tenants or tenants in common is too well established as a common-law institution to become included in the statutory catalogue of partnerships by arbitrarily classifying such tenancies as "joint ventures" or "groups." [106]

The history of the various revenue acts, as well as the numerous rulings of the Bureau on the subject of such tenancies, indicates clearly that Congress never intended such tenancies to be regarded as taxable units, although their legal existence has always been recognized.[107]

Thus, a tenancy in common or a joint tenancy is not to be treated as a partnership for income tax purposes merely because it happens to have some of the characteristics of a joint venture or some other kind of simple association. Nor can such tenancies be classified as an association taxable as a corporation merely because of the same characteristics.

The general rule is that, where property is held by two or more persons as tenants in common or as joint tenants, they may improve it, operate it in their joint capacity, and derive and divide the proceeds thereof in proportion to their ownership without becoming taxable as a corporation.[108] Substantially the same rule has been applied even in the case of the development of lands for mining, for purposes of subdivision or for sale, where it appears that the parties have maintained the relationship of tenants in common to the property involved.[109]

On the other hand, the conclusion appears equally obvious that the mere ownership of the property as tenants in common or as joint tenants will not avoid taxability as a corporation, where the tenants set up some form of organization that acts in a collective representative capacity to develop, operate, or sell the property, collect the income or profits, and divide them among the tenants. In such case, the organization will probably be held to have the characteristics of a taxable association, to wit: (a) associates in a common plan or enterprise; (b) a business purpose for profit; and (c) a centralized or representative management similar to that of a corporation.[110]

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[105] I.T. 3930; I.T. 3933; I.T. 3948, *see* footnotes 101, 103. Under the provisions of I.T. 3933 and I.T. 3948, taxpayers having joint operations or unit operations were given additional time in which to amend their agreements to conform to the principles set forth therein. These rulings should be consulted in order to insure compliance.

[106] *See Estate of Edgar S. Appleby*, 41 B.T.A. 18 (1940), and the excellent discussion of this subject, as well as the earlier cases there cited.

[107] *See* I.T. 1604, II-1 C.B. 1 (1923); I.T. 2082, III-2 C.B. 176 (1924).

[108] *Horace P. Robinson, et al.*, par. 45,357 Prentice-Hall Memorandum T.C. (1945).

[109] *Jacob Larus*, par. 41,067 Prentice-Hall Memorandum B.T.A. (1941); *Rupple* v. *Kuhl* (D.C. Wis.), 81 F. Supp. 318, 37 AFTR 781 (1948); affirmed (7 Cir. 1949) 177 F. 2d 823, 38 AFTR 845. C. A. *Everts, et al.*, 38 B.T.A. 1039 (1938).

[110] *Estate of Becker*, par. 43,311 Prentice-Hall Memorandum T.C. (1943).

20. The Internal Revenue Code of 1954

From the foregoing discussion, it seems obvious that it is almost impossible, under present conditions, to set forth any clear-cut definition of what constitutes a taxable association, or to prescribe with accuracy a test by which taxability of such an association can be determined. In the light of the many inconsistent decisions and the incongruous language in certain of them, it was to be hoped that Congress, in its enactment of a new Internal Revenue Code, would prescribe a fairly simple definition or test of such an association. Unfortunately, this was not done, and Section 3797(a)(3) of the Internal Revenue Code of 1939 was re-enacted without change as Section 7701(a)(3) of the Internal Revenue Code of 1954.

In view of its enactment, however, the footnotes to the text have been amended to show both Code sections and cross references, where appropriate. In addition to that, the entire article has been re-examined to assure reference to certain cases decided and Internal Revenue Service rulings issued up to the date of enactment of the new Code.

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Corporate Organization and Operation

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The Federal government for many years has regarded corporations as a ready subject for the exercising of its taxing powers. Actually, as is well known, United States corporations are creations of the respective states. Individual corporations were originally created by legislative enactment. As this form of business organization became more popular, the respective state legislatures adopted laws governing their creation.

Generally speaking, corporations are divided into two so-called categories—*public* and *close*. The distinction is not always precise and clear. What is meant, however, is that where ownership of the corporation is distributed among a comparatively large number of persons, the corporation is deemed to be public, and where the ownership of the corporation is distributed among a comparatively limited number, the corporation is deemed to be a close corporation.

It might be preferable to say that there are close corporations, public corporations, and *widely held* corporations. If these categories are used, then public corporations can be defined as those whose shares of stock are traded in such places as the respective stock exchanges and over-the-counter markets.

When we speak of a close corporation, we are referring to partners who have decided to go into business together and instead of operating under the partnership form, have decided to operate under the corporate form.

Widely held corporations are those whose stock is more extensively distributed than that of close corporations, but whose shares are not publicly held in the sense we have just described. The ownership of these widely held corporations is usually vested in a number of partners who have entrusted their affairs to a smaller group and have chosen the corporate form under which to operate.

The corporate form of doing business has advantages that are well known. To mention but a few of them, the corporation offers the individual owners the right to limit their personal liability to the amount of their investment. In practice many owners of close corporations personally guarantee the corporate obligations. Whether or not this is advisable or desirable is a question with which we are not here concerned.

The corporate form also provides flexibility of ownership in that aliquot parts of that ownership are readily transferable by sale, gift, and so on. It is also more feasible in the corporate form to reward employees by giving or selling them stock ownership, or by making available to these employees options to acquire capital stock. The corporate form lends itself to choice of management, and many other things along these lines which are very difficult and cumbersome to accomplish under partnership operation.

The corporation is owned by the stockholders. The stockholders in turn elect a board of directors who govern the corporation in an over-all sense. The board of directors in turn elects officers who manage the affairs of the corporation.

1. Points to Consider

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We are here concerned with Federal income tax considerations insofar as they pertain to corporations. Our comments are applicable to the so-called close corporation. The considerations herein mentioned, however, are not necessarily confined to these close corporations but may be applicable to corporations whose stock is more widely held, and may also be applicable to those corporations whose shares are traded on the public exchanges.

Persons who have in a current taxable year sustained losses in personal ventures, and who are about to engage in a new business that is expected to be profitable, may find it to their advantage taxwise to begin business as a partnership. Incorporation should be postponed until they have used their "other losses" as tax offsets against their business profits.

Also to be considered are expected business losses in the first period of operation that could be used by partners to offset such other income as they might have.

The corporate structure lends itself also to the setting up of separate corporate entities for different enterprises by the same owner or owners. For example, it is quite common for separate corporate entities to be set up for different real estate ventures. In this manner, undesirable ventures may be liquidated or otherwise disposed of without injury to other more successful operations.

It is sometimes possible to effect tax savings by the establishment of separate corporate entities instead of having a single corporate structure. The use of subsidiaries and divisions should always be the result of sound financial reasoning and calculations, and be supported by good business purpose.

Incorporation of a separate branch of a business may be desirable because of the geographical location of plants, different products manufactured, segregated management, and other factors. A new product or an untested nonrelated product might be turned over to a subsidiary by a parent corporation that produces a high quality product. The parent may not want to be associated with a low-priced product or may try to avoid public confusion in advertising the same company name with reference to wholly different products.

It is desirable to have a subsidiary, when created, adequately capitalized so that it can carry normal financial strains.

Management must not indicate a disregard of the subsidiary's interests as compared to its parent.[1] Care should be exercised that the subsidiary have its own assets recorded on its own records.[2] The subsidiary should also have its own bank account and hold its own board of directors' meetings with the proceedings properly recorded in its own minute book.

If one entity is likely to operate at a loss and the other at a profit, it may be preferable to operate the subsidiary as a division and not as a separate corporation, so as to permit the offset of losses against profits without incurring the 2 per cent additional tax when filing consolidated returns.

It might in such cases be desirable to liquidate a subsidiary to accomplish the foregoing.

Under the Internal Revenue Code of 1954, when one corporation acquires the assets of another in a tax-free transaction, the acquiring corporation steps into the position of the acquired corporation. Therefore, a net operating loss of a subsidiary can be applied by the acquiring corporation against income earned by the merged company after the date of acquisition.

Under present Federal tax rates, there is a current tax saving if the taxable income of one or more subsidiaries is $25,000 or less.

Separate subsidiary corporations for operations within each of several different states may have decided advantages in reduced state taxes and the avoidance of local restrictions on "foreign corporations."

Ownership in a corporation, as we have said, is represented by shares of stock. These shares of stock are often divided into types, usually *common* and *preferred*. Preferred ownership generally represents corporate capital that is entitled to earnings before any earnings are allocated to the equity owners known as common stock owners. The preferred stockholders often receive a first lien on the assets of the corporation, which means that in the event of liquidation, after the creditors are paid, the preferred stockholders are paid and the remainder goes to the owners of the common stock.

Earnings of a corporation may be taken out at capital gain rates where a substantial amount of redeemable nonvoting preferred stock is issued when the corporation is organized. If only preferred stock is owned by a stockholder, where others own common, the preferred can be retired and, under present rules, the profit measured by accumulated dividends will be taxed as capital gains.

Redemption of some of the preferred stock held by persons who also own common stock might have the effect of a dividend.[3]

Redemption of preferred stock has been held not to be a dividend where common stockholders had subscribed for such stock upon incorporation of a partnership in order to permit repayment of outside loans, and where redemption occurred during same year.[4]

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[1] *Atwater* v. *Fall River Pocahontas Collieries*, 119 W. Va. 549, 195 SE 99 (1938).

[2] *Franklin Process Co.* v. *Western Franklin Process Co.*, 308 Ill. App. 302, 31 NE (2d) 364 (1941).

[3] *Marie W. F. Nugent, Head Trust*, 17 T.C. 817.

[4] *G. E. Nicholson*, 17 T.C. 1399.

2. "Thin" Corporations

At the time of formation of a corporation, the owners often desire to invest a comparatively limited sum of money. In cases where the immediate capital requirements are greater than the capital invested, they prefer to lend to the corporation these extra sums with a view to withdrawing them as the corporation is in the position to repay these loans.

Generally, when the corporate owners advance sums to the corporation in excess of their original investment, these advances are represented by bonds, notes, or other forms of indebtedness issued by the corporation. In some instances, these bonds or notes may be secured—in other words, guaranteed—by assets of the corporation. Usually these obligations bear interest, and such interest is a deductible expense to the corporation for Federal income tax purposes. Correspondingly such interest is income to the individual owner of the corporate obligations.

This combination of capital investment and loan has given rise to the so-called *thin* corporate structure. The structure might be said to be thin when the capital is very small in comparison to the corporate obligations. These thin corporate setups have been subject to attack by the Internal Revenue Service.

Capitalizing a corporation partly with bonds or notes and partly with stock carries with it certain risks. It is not known what ratio of debt to equity investment would be acceptable to the Internal Revenue Service.

Failure to satisfy the Service usually results in having the debt treated as an equity investment, the disallowance of the interest deduction to the corporation, and the levying of the corporate tax in consequence.

This disallowance of the corporate interest expense does not afford corresponding relief to the recipient who has paid a tax thereon, for the reason that both the interest payments and any repayment of debt would be treated as dividend payments to the stockholders.[5]

There have been a number of court cases on this subject. In one case, the Tax Court upheld a 3½ to 1 ratio of debt to equity capital.[6] The Treasury has since announced acquiescence.[7] In an earlier case, the Tax Court denied the deduction of interest on "registered notes"—which varied from 2 to 10 per cent depending on profits, and could be deferred—where the ratio was 4 to 1.[8] In this case, it appears that factors other than the indebtedness to capital ratio caused the disallowance.

Actually, there is no ground for assuming that any fixed ratio is preferable. The needs, circumstances, and intent surrounding the particular situation would seem to govern the ratio.[9] It is also important that the corporate liability be one that carries with it a reasonable indication of an intent to repay. In the absence of any signs of an attempt to repay, it is apparent that the danger of having the loan accounts considered capital has been enhanced.

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[5] *R. E. Nelson,* 19 T.C. 72 (1952).

[6] *Ruspyn Corp.,* 18 T.C. 93.

[7] 1952 I.R.B., No. 24 (p. 1).

[8] *Talbot Mills,* 326 U.S. 521 (1946).

[9] *Earle* v. *W. J. Jones & Son, Inc.,* F. 2d (9 Cir. 1952), affirming U.S.D.C. District of Oregon, June 12, 1951 (a six to one ratio was approved). *Erard A. Matthiesen,* 16 T.C. 781 (1951), aff'd 194 F. 2d 659 (2 Cir.) (Capitalization known to be inadequate in advance).

Corporate setups have provided for several classes of capital stock so that in the event it is desired to liquidate one type of capital stock, such liquidation might be deemed to be subject to the capital gains tax. In this connection, it becomes appropriate to point out that Section 115(g) of the 1939 Internal Revenue Code provided that if the liquidation was in "the nature of" a payment of a dividend, to the extent that there was a surplus, such dividend was subject to ordinary income taxes at normal rates instead of at capital gain rates.

In substance, the same principles with respect to corporate distributions that are "in the nature of a dividend" apply under the new 1954 Revenue Code. They are enumerated in Sections 302, 303 and 304.

In a recent situation a stock dividend in preferred stock was declared on outstanding common stock. That stock dividend was tax free. The stockholders then sold the preferred stock to other interests. Subsequently the corporation redeemed the preferred stock.[10] The foregoing was in effect a plan under which corporate earnings were distributed at capital gain rates. Under the new Internal Revenue Code of 1954, such redemptions would be taxable under Sec. 306 as dividends to the extent that there is an applicable surplus. The capital gain treatment, however, would still apply where (1) the original stock dividend was a tax-free stock dividend of common stock on common stock; (2) the stockholder's disposition completely terminated his interest; (3) there is a redemption in complete or partial liquidation of the corporation; (4) the stockholder can prove that the redemption was not for purposes of tax avoidance; (5) the distribution in redemption is deemed to have left the shareholder with a substantially disproportionate interest in the corporation (a stockholder has been left with a "substantially disproportionate interest" when he remains with less than 80 per cent of the stock he had before redemption and his ownership in voting power is less than 50 per cent after redemption); and (6) the distribution is in partial redemption, and such redemption takes place in the year of adoption of plan or the following year and is not essentially the equivalent of a dividend.

Almost all thin corporations are closely held or family corporations, where a few dominant stockholders can conduct the business and set corporate policy as they see fit.

The Treasury may disallow bad debt losses claimed by stockholders on uncollectible loans made to such thin corporations, whether or not such loans are transferable or evidenced by securities.

The disallowance is usually based on the contention that the securities claimed by the taxpayer to represent debts are really equity capital at the risk of the business and therefore the loss sustained is a capital loss instead of a bad debt loss.

If the debt represents substantially the entire investment in a new corporation, there is a strong probability that it will be classified by the Treasury as risk capital, and it will not be recognized as debt. The fundamental characteristics of debt are lacking where loans or advances by stockholders to a corporation are completely at the risk of the business and, in effect, represent purchase of proprietary interests.[11]

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[10] *Chamberlin,* 207 F. 2d 462.

An important factor in determining whether advances to a corporation are contributions to capital or loans is the intention of the parties. Where the bona fides are not questioned, the fact that the lender is the sole stockholder and corporation's business is not prospering is not a basis for disregarding the true intention or the right of the parties to create debts.[12]

Similarly, where all the stockholders advance funds in proportion to their stockholdings, and it is evident that they expect to be repaid, the amounts have been considered loans and not further investments.[13]

However, when the loans from stockholders are in direct proportion to their stockholdings, the Treasury and the Tax Court may scrutinize the transaction closely but will not treat the loans as additional investment, regardless of intent.[14]

It follows that great care must be taken when the corporation is established, to provide reasonable flexiblity so that the owners might withdraw unneeded funds without undue tax injury. The question is often raised when comparing corporate tax consequences with partnership tax consequences, whether the partnership technique is not actually more economical. The Internal Revenue Code of 1954 for the first time allowed a credit to taxpayers on dividends received. For 1954, the first $50 of dividends could be excluded from income, provided the taxpayer's year ended after July 31, 1954. On dividends received after July 31, 1954, a credit against the tax is allowed of 4 per cent of such dividends but not in excess of 2 per cent of taxable income for years before 1955 and 4 per cent of taxable income beginning with year 1955. If considered that the corporation pays a tax on its earnings and the individual pays a tax when he withdraws those earnings as dividends, it might be true that the partnership form is more economical. The partnership entity as such pays no tax, as the individuals merely pay a tax on the earnings of the partnership, regardless of whether or not such earnings are withdrawn.

Nevertheless, as a practical proposition corporate life is perpetual, and in the average situation the benefits of corporate operations outweigh possible extra tax costs.

When it is considered that approximately 650,000 corporations in the United States filed income tax returns for 1949 and that at least one-half had net income under $25,000 after the deduction of salaries to their officers, it follows that the corporate form is actually more economical in most cases. This is particularly due to the fact that the first $25,000 of corporate income is subject to the comparatively low rate of 30 per cent.

The new Internal Revenue Code, Sec. 1551, denies the surtax exemption of $25,000 and the accumulated earnings credit of $60,000 allowed under Sec. 535, to corporations created by a transfer of assets from another corporation, if such transfer was for the purpose of avoiding taxation.

Under the Internal Revenue Code of 1954, certain types of partnerships may elect to be taxed as corporations. Such election cannot be revoked unless there is a 20 per cent change in ownership. These partnerships must have (1) no more than 50 members: (2) no partner owning more than 10 per cent may own more than 10 per cent of any other unincorporated business that reports as a corporation; and (3) the business is to be one in which capital is a material income-producing factor or in which at least 50 per cent of the gross income comes from trading as a principal or from acting as a broker in realty, stock, securities, or commodities transactions.

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[11] *Schnitzer, et al.*, 13 T.C. 43 (1949), aff'd (9 Cir. 1950), 183 F. 2d 70. *American Cigar Co.* v. *Commissioner*, 166 F. 2d 425.

[12] *Alma Spreckels*, T.C. Memo. op., 8 T.C. M. 1113; *Ives*, 5 B.T.A. 934, Dec. 2015 (acq.); *Ida M. Brown*, B.T.A. Memo. op., Dec. 12—823 P.

[13] *Portuguese-American Tin Co.*, T.C. Memo. op., 2 T.C.M. 270, Dec. 13, 291 M.

[14] *Wilshire & Western Sandwiches, Inc.* (9th Cir. 1949), 175 F. 2d 718, reversing T.C. Memo., June 29, 1948.

3. Fiscal Year

When a corporation is formed, it is of importance to the owners to determine when the corporate fiscal year should end.

A number of considerations may determine the choice. Many concerns like to have their fiscal years close at a time when their inventories are lowest, so that the process of taking inventories is correspondingly easier. A period of low inventories usually coincides with a more favorable cash and accounts receivable position and may produce a more attractive statement for credit purposes.

In establishing the fiscal year, consideration should be given, insofar as it is possible to do so, to the tax position of the individual owners of the corporation. Compensation to the owners in the form of salaries can be set up on either a weekly, monthly, or yearly basis. If the corporate concern has commenced operations on some date other than the beginning of the calendar year, it is often desirable that the fiscal year of the corporation end 12 months after its beginning.

If that is done, corporate compensation to the individual owners need only be credited at the end of the corporate year. In that way, the individual income tax is actually deferred from one taxable period to another, as most individuals are on a calendar-year basis.

For example, assume Mr. A reports his income on a calendar-year basis, but his $25,000 of income was from concerns other than from his corporation which commenced operations on February 1st. Assume also that the corporation is able to pay Mr. A a salary of $25,000 per annum, but that such determination of his compensation is not decided upon until January 31 of the following year. Mr. A's income tax returns for the first period of the corporate existence would include only his income from other sources, namely $25,000. Only in the second year of the corporate existence would his personal income tax returns include the compensation credited to him by the corporation at the end of the previous fiscal year.

In this way, Mr. A has permanently deferred a tax on 11 months of income from his corporation.

Under such a set of circumstances, payments by the corporation to Mr. A and his co-owners would throughout the year be charged to an advance account and the salaries would be determined at year-end.

Requirements of withholding tax could be met by Mr. A either by his filing an estimated income tax return for the year in which such salary is includible in his return, or by the corporation withholding an appropriate percentage and charging his account at the date of determination of the compensation.

When establishing the fiscal year, careful consideration must be given to the corporate tax. The prevailing tax on corporate income is 30 per cent on the first

$25,000 and 52 per cent on all income over $25,000. It may therefore be desirable to end the first fiscal period at the approximate date that the net taxable income has reached about $25,000.

It is also important to remember that 50 per cent of the corporate tax is due within 2½ months after the end of the fiscal period and the balance is payable within three months thereafter. Commencing with the year 1955 corporations whose expected tax liability is in excess of $100,000 will be put on a pay-as-you-go system, so that in 1955 they will in September and December be required to pay 5 per cent of their estimated tax in excess of $100,000 in each of those months.

The system of estimating in advance is being stepped up in each year so that in subsequent years corporations will be paying an additional 5 per cent of their estimated tax in September and December so that by 1959 these installments will each be 25 per cent.

4. Salaries, Bonuses and Expense Accounts

The corporate owners who are active officers are entitled to compensation for their services. It is important as soon as possible after the inception of the corporation to establish a pattern of compensation. In most instances, as explained above, it is desirable to establish this pattern at the close of the first fiscal year of operation.

This latter observation does not apply to expense accounts of officers. If the officers incur expenses in the course of their duties, they are entitled to reimbursement from the corporation, and it is desirable that this pattern be established without undue delay. Flat reimbursements for expenses incurred, when made at the end of a fiscal period, are subject to unusual scrutiny, and substantiating such items is often difficult. Expenses drawn throughout the period must also be substantiated but, when currently accounted for, present less difficulty.

It should be borne in mind that the establishment of a proper corporate salary to the individual officers has been the subject of controversies between the Federal government and the taxpayer for many years. The courts have usually resolved these cases on the basis of the evidence that has been presented to them by the officers, outlining the services rendered. Many salaries and bonuses are set not only on the basis of services rendered, but also on the basis of earnings realized. Where the payments in the guise of salaries are actually dividends, and the tax authorities so find, then the payments will be disallowed as corporate deductions and the individual recipients are compelled to pay an income tax to the same extent as they would have if the compensation had been allowed. In effect, then, these payments are treated as dividends instead of compensation.

The important thing is to develop a consistent pattern, substantiated by evidence which appeals to reason and logic. It is important to note that compensation, interest, and other unpaid expenses accrued and credited to the account of a stockholder holding more than 50 per cent of the stock must be paid [as prescribed in 1954 IRC § 267; 1939 IRC § 24(c)(3)] within the taxable year or within 2½ months after the close thereof. Otherwise such compensation will be disallowed as a deduction to the corporation.

A deduction of unpaid salaries accrued to the account of a stockholder holding exactly 50 per cent of taxpayer's stock was considered proper, since the condition prescribed in 1939 Code Sec. 24(c)(3), which refers to persons holding "more than" 50 per cent of the stock was not present.[15]

If the amount accrued by the corporation is included in the individual stockholder's income for the taxable year in which or with which the taxable year of the corporation ends, regardless of whether or not the amount is actually paid within 2½ months after the close of that taxable year, the deduction is permitted under Code Sec. 267. Also, in this connection, the test has been whether or not the income was includible in the creditor's (stockholder's) income, rather than whether it was actually included by him.[16]

Some corporations short of funds have issued notes in favor of the payee, and such notes have been deemed to be valid payments.

Many corporations, smaller in type, follow a practice of paying funds to the owners and charging such withdrawals as loans to the officers or stockholders. There have been occasions where such advances or loans have been considered taxable in the hands of the stockholder as dividends.[17] The determining factor is the intent to repay and the evidence that some part of the advance was repaid in accordance with a predetermined plan.[18]

In determining what desirable compensation would be to the officers, it is advisable to (1) set up a pro forma statement of income and expenses; (2) calculate the net profit before salaries and after proposed salaries; (3) calculate the resultant corporate income tax; and (4) calculate the tax effect to the individual owners of the compensation decided upon. With these figures as a basis, determine what the salary setup should be, both in the light of current operations and the future prospects of the corporation.

This pro forma estimated calculation of earnings and taxes should also include an estimate of dividends to be declared and the tax effect upon the individuals involved.

The subject of dividends brings to the fore the famous Section 102 of the 1939 Internal Revenue Code, which in the 1954 Code is covered by Sections 531 through 537. Section 102 was enacted originally to discourage corporations from accumulating surplus beyond the reasonable needs of the business. Such accumulations when found to be in excess of the reasonable requirements of the business are subject to a penalty tax of 27½ per cent on the first $100,000 plus 38½ per cent on all accumulations in excess of $100,000 of the amount of income which the corporation allegedly accumulated improperly. Generally speaking, the first $60,000 [Sec. 535(c)(2)] of accumulated earnings is not subject to tax because of unreasonable accumulations of earnings. A credit is also allowed for dividends paid within 2½ months after the end of the taxable year [Sec. 563(a)], and the income tax may be deducted on an accrual basis [Sec. 535(b)(1)].

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[15] *Hewitt Rubber Co. of Pittsburgh*, T.C. Memo. op., 6 T.C.M. 1258.

[16] *Michael Flynn Mfg. Co.*, 3 T.C. 932.

[17] *Regensburg* v. *Commissioner*, 144 F. 2d 41, cert. den. 323 U.S. 783 *M. Jackson Crispin*, 32 B.T.A. 15.

[18] *Moses W. Faitoute*, 38 B.T.A. 32. *Rollins C. Reynolds*, 44 B.T.A. 342. *Alvin H. Phillips*, B.T.A. Memo.

5. Carry-Forwards and Carry-Backs

An important consideration in determining the corporate fiscal and tax policy is to bear in mind that a business is entitled to deduct its losses for any one year from the profits of five succeeding taxable years, after first applying such loss against the profits of the two preceding years. This provision was enacted to help new corporations who in their early years find it difficult to make a profit, but hit their stride after several years of operation.

Internal Revenue Code Sec. 172 (1939 Sec. 122) now provides that a corporate loss is first carried back two years and then to the extent that it is not absorbed, such loss is carried forward to the year immediately preceding the taxable year and applied against profits of that year, if there were any. To the extent that the loss has not been absorbed by the two years preceding the taxable year, such loss may then be carried forward to the earnings of the next succeeding five years after the taxable year until the loss is absorbed.

Under these circumstances, many corporations find it desirable to establish a pattern of officers' compensation and expense accounts, realizing that any new loss contributed to by any such compensation or expense account would be available as a deduction from profits later realized.

Such a procedure would find many corporate officers in the position of paying individual income taxes on what may turn out to be withdrawals of capital from their corporations, which are not realizing profits. Whether or not this is desirable policy depends entirely upon the needs of the individuals.

6. Real Estate

It is often desirable in cases where, for example, a manufacturing corporation buys real estate, that such real estate be purchased by a separate corporate entity. In some cases it might prove desirable to have such real estate owned individually, either by one or more of the corporate owners of the manufacturing enterprise, or by their spouses, or by a combination of both. In this manner, the manufacturing entity obtains a deduction for a reasonable rental value of the premises, and corresponding income is either income to the individual or income to his corporation, if there is a corporation owning and operating the property.

In any relationship between one corporation and another owned or controlled by approximately the same interests, the charge for rent and other services must be reasonable, otherwise disallowances of deductions might ensue.[19]

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[19] *Limericks, Inc.,* 7 T.C. 1129.

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3

How to Operate Partnerships

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The Internal Revenue Code of 1954 attempts to bring certainty to the areas of partnership taxation that previously abounded with confusion. To accomplish this result, Subchapter K[1] of Chapter 1 of the new Code sets up a comprehensive set of rules governing (1) the taxation of partners; (2) the dealings between partners and their partnerships; (3) the transfer of partnership interests; and (4) the organization, reorganization, and termination of partnerships. Many of the rules set forth in this subchapter are new; others are codifications of pre-1954 law, Regulations, and court decisions. The purpose of this chapter is to explain the provisions of the new law and show how they affect the various operations and transactions that normally concern the individual partner and the partnership.[2]

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[1] 1954 IRC §§ 701-771.

[2] This chapter does not undertake any discussion of family partnership problems. That subject is covered in the chapter entitled "The Family Partnership as an Income-Splitting Technique," by Robert K. Lifton. Nor does this chapter discuss the election available to partnerships to be taxed as corporations. For a discussion of that election, see the chapter entitled "The Election of an Unincorporated Enterprise to be Taxed as a Corporation," by Martin Wallace.

2. How a Partner Reports His Share of Partnership Income and Loss

a. Reporting earnings. Partnerships as such are not subject to income taxes. They are merely computing and reporting entities. Each individual partner is liable for the income taxes on his distributive share of the partnership's taxable income.[3] In computing its taxable income for its information return, the partnership reports certain items of income and deduction separately. Each partner then picks up his proportionate share of these items and reports them on his own tax return. These separately enumerated items include (1) short and long term capital gains and losses; (2) gains and losses from the sale or exchange or involuntary conversion of business property; (3) charitable contributions; (4) dividends to which the exclusion provided in Section 116 or the credit provided in Section 34 apply; (5) foreign taxes paid; (6) partially tax-exempt interest; and (7) other items that may be required by regulations.[4] Furthermore, the net operating loss deduction, if available, is claimed by each individual partner, not the partnership.[5]

Generally, the partnership, as the reporting entity, makes the various elections available under the law. For example, the partnership determines whether to use the cash or accrual accounting method, which depreciation method it is to use, and whether to report installment sales by the installment method. However, each partner makes his own election as to how he will treat his share of foreign taxes paid by the partnership—as a deduction from his income, or as a credit against his tax.[6] This election has to be the partner's, rather than the partnership's, because the partnership pays no income taxes and would have no tax against which it could elect to credit the foreign taxes paid.

b. Determining a partner's share of income or loss. Normally, a partner's share of the partnership's income or loss, or any income, deduction, or credit is to be determined in accordance with the partnership agreement.[7] However, many partnership agreements only cover the division of income or loss. Where nothing is said about the division of particular items, the profit-and-loss-sharing ratio of the partnership agreement governs the division of such items for tax purposes.[8] If the partnership agreement has a different ratio for sharing income than the agreed ratio for sharing losses, Congress has indicated that the ratio to be applied to specific items not covered in the partnership agreement depends on whether the partnership had taxable income or a net loss in the year in question. If it had income, the income ratio is applied to the items in question; if it had a loss the loss ratio is used.[9]

Partners can, of course, agree among themselves to any division of profits and losses generally, or any particular items of income, deduction, or credit, and such agreement will be respected for tax purposes. However, if tax avoidance or evasion was the principal motivating purpose for the sharing agreement as to a particular item, such agreement will be disregarded and the general profit or loss sharing ratio will be applied to that particular item.[10]

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[3] 1954 IRC § 701.
[4] 1954 IRC § 702.
[5] 1954 IRC § 703(a)(2)(E).
[6] 1954 IRC § 703(b).
[7] 1954 IRC § 704(a).
[8] 1954 IRC § 704(b).
[9] Senate Report No. 1622, 83d Congress, 2d Session (1954), page 379.

An illustration of a situation where the agreed-upon division of certain items of income or loss might be set aside because of tax avoidance or evasion and the general profit-and-loss ratio substituted is the following: The provisions of a partnership agreement allocate all partnership loss on the sale of depreciable property used in trade or business to one partner, or allocate a greater part or all of foreign tax payments to one partner, while allocating to the other partner or partners an equivalent amount of partnership loss or deduction of a different nature.[11]

Special allocations by a partnership can, however, have substantial economic effect and not be mere devices of reducing taxes of certain partners. Examples of such permissible special allocations are (1) permitting a partner who is a Puerto Rican resident to receive a percentage of the income derived from sources within Puerto Rico that is greater than his distributive share of partnership income generally; and (2) permitting one partner to receive all of the partnership's tax-exempt income while the other partner receives all of the partnership's dividend income.[12]

Profit- and loss-sharing problems sometimes arise in connection with contributed property. For example, partner A may contribute to the partnership a piece of property having a fair market value of $1,000, but an adjusted basis in A's hands of $800. Partner B also contributes a piece of property having a fair market value of $1,000. But this property has an adjusted basis in his hands of $1,000. The basis of each piece of property to the partnership is the same as it was in the hands of each partner prior to the contribution.[13] How shall Partners A and B claim depreciation on these two pieces of property? How shall they divide any gain or loss on the sale of these properties?

If the partnership agreement does not provide otherwise, depreciation, depletion, and gain or loss with respect to the contributed property are to be allocated in the same manner as if the property had been purchased by the partnership.[14] Generally, this means that such items would be allocated in the usual profit-and-loss-sharing ratios. However, such an arrangement may be considered as being unfair by the partner who had the higher basis for his contributed property. Such inequities may be eliminated by the partners themselves. They may agree to allocate depreciation, depletion, and gain or loss in such a manner as to take into account the disparity between the bases of the contributed properties.[15]

In computing a partner's distributive share of the partnership's loss, a limiting factor must be taken into account. A partner's loss is allowed only to the extent of the adjusted basis for his partnership interest.[16] The deduction for the excess is allowed only at such time as it is repaid to the partnership. This repayment may be by a direct contribution to the partnership's capital or by the partnership's recoupment out of the partner's share of subsequent partnership earnings.[17]

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[10] 1954 IRC § 704(b)(2).

[11] Senate Report No. 1622, 83d Congress, 2d Session (1954), page 379.

[12] *Ibid.*

[13] 1954 IRC § 723.

[14] 1954 IRC § 704(c)(1).

[15] 1954 IRC § 704(c)(2).

[16] 1954 IRC § 704(d).

c. Partners' salaries and interest payments. Before the 1954 Code took effect, salaries and interest payments paid to partners were considered to be distributions of partnership profits. The 1954 Code adds a new concept in connection with these payments. It treats the payments—where they are guaranteed, regardless of whether or not the partnership has sufficient income to cover them—as if they were made to complete outsiders. That is, these payments are treated as deductions by the partnership, reducing its taxable income.[18] It should be noted, however, that this change made by the 1954 law is more a change of form than of substance. This conclusion follows from the requirement that the individual partner report the salary or interest payments he receives at the same time he would ordinarily report his distributive share of his partnership income.[19] He would not, therefore, report these salary and interest payments when he receives them, as he would if they had been received from another employer or debtor.[20]

The lack of change of substance by the new law can be seen in the following example. Assume A and B form a partnership, agreeing to share profits and losses equally after allowing A a guaranteed salary of $10,000. The partnership's profit before A's salary is $16,000. Under the law before the 1954 Code, A's distributive share of the partnership profits would be $13,000 ($10,000 received as salary and $3,000 as his half share of the remaining profits) and B's share would be $3,000 (one-half of the profits after the payment of A's salary). Under the 1954 Code, A still has $13,000 taxable income and B still has $3,000. The $10,000 salary reduces the $16,000 partnership profit to $6,000. Each partner picks up $3,000 of that amount. In addition, A reports his entire $10,000 salary as income at the same time as he reports his share of the partnership profits.

d. When a partner reports income or loss. A partner reports his distributive share of the partnership income or loss (whether or not he actually receives it) for the partnership tax period which ends within his tax reporting year.[21] Thus, if both the partner and partnership used a calendar year as their tax years, the partner would report his share of the partnership's 1955 income in his own 1955 income tax return. Where the partnership uses a fiscal year (for example, one ending March 31) and the partner uses a calendar year, the partner would report his share of the partnership income for the partnership year ending March 31, 1955 in his 1955 tax return, even though nine months of the partnership year fell in 1954.

Prior to the 1954 Code, it was common for partnerships to choose fiscal years other than the tax years used by the partners. This allowed the partners to postpone the payment of taxes on partnership profits for as much as eleven months (e.g., where the partnership fiscal year ended January 31 and the partners used a calendar year). The 1954 Code restricts the free choice of fiscal years by partnerships.

Beginning April 1, 1954,[22] a partnership cannot adopt or change to a taxable year other than that used by all of its principal partners unless it can show a good business purpose for doing it.[23] Nor may a principal partner change his tax year to any other year than that used by the partnership unless he has good business purpose for doing so.[24] A *principal partner* is defined as a partner having an interest of 5 per cent or more in partnership profits or capital.[25]

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[17] Senate Report No. 1622, 83d Congress, 2d Session (1954), page 383.

[18] 1954 IRC § 707(c).

[19] See Section 2(d) of this chapter.

[20] Senate Report No. 1622, 83d Congress, 2d Session (1954), page 387.

[21] 1954 IRC § 706(a).

[22] 1954 IRC § 771(b).

Much difficulty in forming new partnerships may be encountered under the rules set forth above where the individuals who propose to form a partnership already use different taxable years for reporting income. If each is to be a principal partner, the partnership could not adopt a fiscal year that coincided with the one used by all of its principal partners. Similar difficulty would also be encountered where an individual who is already a partner in one partnership is to become a partner in another partnership, and his partnership year does not coincide with the other partners of the proposed new partnership. He might not be able to change his fiscal year to coincide with the other partners, because this change might give him a different tax year than that of the first partnership in which he already is a partner. Possibly, reasons such as these will be considered sufficiently good business purposes by the Commissioner to allow partnerships encountering these problems to use fiscal years that differ from those of some or all of the principal partners.[25a]

3. How to Handle Dealings Between a Partner and His Partnership

Before the 1954 Code took effect, the rule as to the proper treatment of transactions between a partnership and any of its partners was not clear. The statute did not specifically cover the situation, and the courts were not consistent in their treatment of this problem.[26] The new Code sets out specific rules in this area.

The general rule is that, where a partner deals with his partnership other than in the capacity of a partner, he shall be treated as though he were an outsider.[27] Transactions contemplated by this rule include (1) sales to or by the partnership, by or to a partner; and (2) service rendered by or to the partnership, to or by a partner. Contributions to the partnership by a partner or distributions by it to a partner are not covered by this rule.[28]

Under this rule, where services are rendered by a partnership to a partner, the payment made by the partner to the partnership would be included in the partnership income. The partner making the payment would then pick up his share of that income when reporting his distributive share of the partnership income. Where the partnership pays a partner for services, it would get a deduction for them, and the partner would pick up the income.[29] Except for the special situations discussed below, gain or loss from the sale or exchange of property between partner and partnership would be reported in the same manner as if these transactions were between strangers.

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[23] 1954 IRC § 706(b)(1).

[24] 1954 IRC § 706(b)(2).

[25] 1954 IRC § 706(b)(3).

[25a] Proposed Regulations indicate that a newly formed partnership may adopt a calendar year without prior permission if all the principal partners are not on the same taxable year. Prop. Inc. Tax Reg. (1954) § 1.706-1(b).

[26] See Senate Report No. 1622, 83d Congress, 2d Session (1954), page 92.

[27] 1954 IRC § 707(a).

[28] Senate Report No. 1622, 83d Congress, 2d Session (1954), page 386.

Where a sale or exchange takes place between a partnership and a controlling partner, the general rule does not apply to losses. Losses in such a case are disallowed. Furthermore, losses are not allowed on sales or exchanges between two partnerships controlled by the same interests. However, should the property be resold subsequently, gain on the resale is only recognized to the extent that it exceeds the disallowed loss on the previous sale or exchange.[30] Control, for the purposes of finding whether a partner is a controlling partner or whether two partnerships are controlled by the same interests, means ownership of more than 50 per cent of the capital or profit interest in the partnership.[31] Indirect ownership is included in determining whether the more-than-50-per-cent requirement is met.[32] Indirect ownership of a capital or profit interest of a partnership includes the ownership of such interest by (1) a partner's corporation; (2) other partnership, estate, or trust of which he is a beneficiary (in proportion to his interest in the corporation, partnership, trust, or estate); (3) brothers and sisters (by whole or half blood); (4) his spouse; (5) his ancestors; and (6) his lineal descendents.[33]

In addition to the special rule disallowing losses, another special rule converts what might otherwise be capital gain into ordinary income. This rule applies to certain sales and exchanges between a partnership and an 80 per cent controlling partner or between two partnerships where there is 80 per cent control in each by the same interests. In the cases covered by this rule, if the property in the hands of the transferee is not a capital asset—e.g., depreciable property, inventory, stock in trade, etc.—the gain on the sale or exchange is ordinary income, even if the transferor would have been entitled to capital gain had the property been sold to an outsider.[34] The control tests (including attribution of ownership) in this situation are the same as in the case of disallowed losses, discussed above, except that more than 80 per cent ownership (instead of more than 50 per cent ownership) of the capital or profit interest in the partnership is required.[35]

As was previously indicated,[36] the rules governing the dealings between a partner and his partnership do not apply to contributions of property to the partnership by the partner. There is no tax effect when a partner contributes property to a partnership. It is considered a tax-free exchange of property for a partnership interest.[37] The result is the same whether the contribution is made to a new or an existing partnership.[38] The cost or other basis the property had at the time of transfer becomes the partnership's basis for the property it has received,[39] as well as the contributing partner's basis for the part of his partnership interest attributable to the contribution of that property.[40]

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[29] But see Section 2(c) of this chapter for a discussion of the treatment of guaranteed salary payments made to partners.

[30] 1954 IRC § 707(b)(1).

[31] *Ibid.*

[32] 1954 IRC § 707(b)(3).

[33] *Ibid.*; 1954 § 267(c)(1), (2), and (4). See also § 267(c)(5) for special rules concerning the second degree of attribution of ownership.

[34] 1954 IRC § 707(b)(2); Senate Report No. 1622, 83d Congress, 2d Session (1954), page 287.

[35] 1954 IRC § 707(b)(2) and (3).

[36] See footnote 28, above, and the text pertaining thereto.

[37] 1954 IRC § 721.

Sometimes, a partnership will assume a liability of a partner, or the contributed property will be subject to a liability. Where the partnership takes over a partner's liability, the effect is to reduce the partner's basis for his partnership interest.[41]

4. How the Transfer of a Partnership Interest Is Taxed

Under the 1939 Code, a sale of partnership interest gave rise to capital gain or loss.[42] The 1954 revision continues this approach,[43] but with this exception: To the extent that the partnership holds unrealized receivables or appreciated inventory as defined by Section 751, a portion of the gain or loss is treated as ordinary income or loss.[44] (See Section 6(e) of this chapter for the definition of unrealized receivables and appreciated inventory.)

To compute the amount of ordinary income, part of selling partner's basis of his partnership interest must be allocated to his interest in the receivables and inventory. This basis is his proportionate share of the partnership basis for these properties. The difference between the portion of the selling price allocated to the receivables and the inventory and his portion of the allocated bases of these items is ordinary income or loss. The balance of his partnership basis is then compared to the balance of the selling price, giving either capital gain or loss.[45] For example, A and B form a partnership to conduct a real estate business. They each contribute $5,000 in cash with which they buy real estate for resale. At the end of the year the property is worth $14,000. A then sells his partnership interest for $8,000. His $3,000 profit is reported as $2,000 of ordinary income and $1,000 of capital gain. As the inventory had appreciated over 140 per cent and was 100 per cent of the partnership property,[46] that portion of the gain is taxed as ordinary income. A's basis for his share of the realty was $5,000 and his share of its value was $7,000. Therefore, he realized $2,000 of ordinary income. Since, the basis applied to the land consumed his entire partnership interest, the remaining $1,000 of the profit is fully taxed as a capital gain.

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[38] Senate Report No. 1622, 83d Congress, 2d Session (1954), page 388.

[39] 1954 IRC § 723.

[40] 1954 IRC § 722.

[41] The assumption of the liability is treated as a distribution of money by the partnership to the partner. 1954 IRC § 752(b). Such distribution reduces a partner's basis for his partnership interest. 1954 IRC § 733.

[42] *Lehman* v. *Commissioner* (2 Cir. 1947), 165 F. 2d 383, 36 AFTR 545; U.S. v. *Landreth* (5 Cir. 1947), 164 F. 2d 340, 36 AFTR 255; *Williams* v. *McGowan* (2 Cir. 1946), 152 F. 2d 570, 34 AFTR 615; *Thornley* v. *Commissioner* (3 Cir. 1945), 147 F. 2d 416, 33 AFTR 684; *Commissioner* v. *Shapiro* (6 Cir. 1942), 125 F. 2d 532, 28 AFTR 1079; *Kessler* v. *U.S.* (3. Cir. 1941), 124 F. 2d 152, 28 AFTR 620. In G.C.M. 26379, 1950-1 C.B. 58, the Bureau conceded that a partner's interest is a capital asset.

[43] 1954 IRC § 741.

[44] *Ibid.*; 1954 IRC § 751(a).

[45] Senate Report No. 1622, 83d Congress, 2d Session (1954), page 401.

[46] This meets the appreciated inventory tests of Section 751(d)(1) requiring that the property's market value exceeds (1) 120% of its adjusted basis to the partnership and (2) 10% of the fair market value of all partnership property.

5. Purchasing Partner's Basis for Partnership Interest

When a person buys a partnership interest, the purchase price he pays generally reflects the fair market values of his share of the partnership properties. And his purchase price becomes the basis for his partnership interest.[47] Similarly, where a partnership interest passes on at the death of a partner, the value of the interest taken for estate tax purposes (which reflects that interest's share in the fair market value of the property of the partnership) becomes the basis of that partnership interest to the one who inherits that interest.[48]

Although the new partners (whether by purchase or by inheritance) reflect the market value of the partnership properties in the bases for their partnership interests, such values are not reflected in the partnership's basis for its assets that have appreciated in value since their acquisition by the partnership. Therefore, if no adjustment is made to the partnership's basis of its appreciated properties in favor of the acquiring partner, the portion of the appreciation attributable to his interest may be taxed twice.[49] To avoid such double taxation, the 1954 Revenue Code allows for an adjustment of the basis of the partnership property to account for difference between the partnership's basis of the new partner's proportionate share in the partnership property and the partner's basis for his partnership interest.[50]

Such an adjustment is made only if the partnership elects to do so.[51] Failure to make such election leaves the partnership's basis for its property unchanged after the transfer of a partnership interest.[52] The aggregate difference between the basis for the partner's interest and the partnership's basis for the partner's proportionate share of the partnership property increases or decreases the partnership's basis for its property. However, such increase or decrease in partnership basis is attributable only to the acquiring partner. Regulations will prescribe the method of allocating the increase or decrease over the partnership assets.[53]

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[47] 1954 IRC § 742.

[48] *Ibid.*

[49] Assume partnership XY has two pieces of property: A, with a basis of $60 and worth $100, and B, with a basis and fair market value of $100. X and Y each has a basis of $80 for his partnership interest. X sells his interest to Z for $100. X reports $20 gain. Subsequently the partnership sells the A property for $100. If the partnership basis of the property remains unchanged, a $40 gain would result from the sale, with Y and Z each reporting $20. The $20 gain reported by Z really duplicates the $20 gain reported by X on the sale of his interest to Z. Similar tax duplication would result in the case of an inherited partnership interest. If X died and Z acquired the interest by inheritance, an estate tax on the $20 appreciation of X's partnership interest would then be duplicated by the income tax on the $20 gain reportable by Z on the sale of property A.

[50] 1954 IRC § 743(b).

[51] *Ibid.*; 1954 IRC § 754.

[52] 1954 IRC § 743(a).

[53] Apparently where the aggregate differential between partner's and partnership's bases is due to only appreciations, or only to depreciations, the apportionment is to be made over the appreciated or depreciated properties in proportion to the relative appreciations or depreciations. See Senate Report No. 1622, 83d Congress, 2d Session (1954), page 396. However, where the net

Assuming the same facts as used in the example in footnote 49, here are the results that would follow had the partnership made the election available under Section 754. The basis for the A property to the partnership was $60, the basis of the B property, $100. Each property had a fair market value of $100. Partner X sold his partnership interest to Z for $100. Thus, the difference between Z's basis for his partnership interest ($100) and his one-half share of the partnership's basis for its property (one-half of $160, or $80) is $20. This $20 is added by the partnership to its basis for the A property. But such increase in basis is attributable to Z only. Thus if proper depreciation on the A property is 10 per cent of its basis, partner Y's share would be one-half of 10 per cent of $60, or $3; Z's share, however, would be one-half of 10 per cent of $60 plus 10 per cent of $20, or a total of $5.[54] If the A property were sold for $100, the gain (disregarding adjustments for depreciation) would be reported as follows: Y would report one-half the difference between the $60 basis and the $100 sales price, or $20. Z's otherwise reportable $20 share of the gain would be further reduced by his additional $20 basis, giving him no gain or loss.[55]

6. How to Treat Partnership Distributions

The 1954 revision of the Internal Revenue Code substantially revamped the rules governing partnership distributions and codified most of them in Subpart B of Part II of Subchapter K. In their order, the sections of this subpart follow step by step the problems involved in an ordinary distribution.[56] The following new concepts are contained in these rules:

1. On a distribution, under certain circumstances, a partner may elect to have his basis reflect an unrealized appreciation of assets.
2. After a distribution, a partnership may adjust its remaining property to reflect differences in bases picked up by a distributee.
3. Payment to a retiring partner or deceased partner's successor in interest will be taxed as ordinary income unless shown to be a payout of his interest.
4. Where a partnership holds appreciated inventory or unrealized receivables

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differential is made up of the differences between appreciations and depreciations, it would appear that the differential should be spread only over the assets which reflect the nature of the net differential. For example, if some assets have appreciated and others depreciated, but the net amount is an appreciation, this net appreciation should be spread only over the assets that have appreciated. See J. Paul Jackson, Mark H. Johnson, Stanley S. Surrey, Carolyn K. Tenen, and William C. Warren, "The Internal Revenue Code of 1954: Partnerships," *Columbia Law Review*, December 1954, Vol. 54, page 1221.

[54] See Senate Report 1622, 83d Congress, 2d Session (1954), page 398.

[55] *Ibid.*

[56] When gain or loss is recognized, Section 731; What is the basis of the distributed property to the distributee? Sections 732 and 733; When can a partnership adjust the basis of undistributed property after a distribution? Section 734; What is the character of the gain or loss on the eventual disposition of the distributed property by the distributee? Section 735; What part of a liquidating distribution to a retiring partner or deceased partner's successor in interest is taxed as ordinary income? Section 736. As for the remaining relevant sections: Section 741 of Subpart C determines the nature of any gain or loss recognized under Section 731; Section 751 of Subpart D affects most distributions where the partnership holds appreciated inventory on unrealized receivables or both; and Sections 754 and 755 relate to problems involving elective adjustments to bases under Section 734.

(or both), certain distributions may result in tax to the distributee and tax to the other partners as well.

These and other important problems are discussed in the following sections.

a. When there is gain or loss. Generally, a distributee partner recognizes no gain or loss on his receipt of a partnership distribution. This is true whether or not the distribution is a current or partially liquidating payment or a payment in complete liquidation. However, there are several important exceptions to that rule.

In a current distribution (or one in partial liquidation), a loss is never recognized, but gain is recognized when the cash distributed exceeds the basis of the distributee's partnership interest.[57] For example, where a partner with a partnership basis of $10,000 receives a distribution of $11,000 in cash, a gain of $1,000 is recognized and taxed at capital gain rates.[58] But no gain is recognized where he receives $3,000 in property and $8,000 in cash. Where a partnership holds appreciated inventory or unrealized receivables (or both) a disproportionate distribution of assets may result in tax to both the distributee and the nondistributee partners. The problems arising in this type of distribution are discussed in Section 6e of this chapter.

In a complete liquidation, as in the case of a current distribution, no gain is recognized except where the cash received exceeds the partner's basis in the partnership.[59] However, loss is recognized where the distribution consists solely of money and unrealized receivables or inventory,[60] or both, and these items exceed the partner's interest in the partnership.[61] But the loss is not recognized if property other than inventory or unrealized receivables is distributed. Where a partnership holds unrealized receivables or appreciated inventory, or both, a disproportionate distribution of assets in a complete liquidation will result in tax to both the distributee and nondistributee partners. See Section 6e of this chapter for a discussion of this problem.

In the liquidation of a retiring partner's interest or that of a deceased partner's interest, ordinary income is realized on the amount of the distribution attributed to the partner's distributive share of income or guaranteed salaries or interest.[62] Capital asset treatment is extended only to the value attributed to the partnership interest.[63] And for this purpose, the partnership interest does not include payments for unrealized receivables which, if present, will be reflected as ordinary income above.[64] However, goodwill may be included as part of the partnership interest if the partnership agreement provides for such payment.[65] But it cannot exceed the reasonable value of the distributee's share of the partnership goodwill.[66] If the distribution includes appreciated inventory, it may come within the provisions of Section 751(b).

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[57] 1954 IRC § 731(a)(1).

[58] Section 731(a) says gain or loss is recognized as if derived from a sale or exchange of a partnership interest. Section 741 considers such gain or loss as arising from a sale or exchange of a capital asset.

[59] Footnote 57, above.

[60] 1954 IRC § 731(a)(2)(B). The distributed inventory does not have to meet the substantial appreciation tests of Section 751(d)(1), but does have to meet the tests of Section 751(d)(2), which includes all items of stock in trade or property held primarily for sale to customers in the ordinary course of a trade or business. See also Section 1221(1).

[61] Loss is recognized as a capital loss. See footnote 58, above.

[62] 1954 IRC § 736(a).

[63] 1954 IRC § 736(b).

[64] 1954 IRC § 736(b)(2)(A).

[65] 1954 IRC § 736(b)(2)(B).

As for the partnership, it recognizes no gain or loss on a distribution.[67] However, if the transaction falls within Section 751(b) ordinary income or capital gain may be realized by the nondistributee partners. (See Section 6e.)

b. How a distributee figures the basis of distributed property. How a distributee determines his basis depends on whether or not he received a current or partially liquidating distribution or one in complete liquidation of his interest.

In a current or partially liquidating distribution, the distributee picks up as his basis of the distributed property the basis it had in the hands of the partnership immediately before the distribution.[68] But this carryover rule is limited. The basis of the distribution cannot be more than the distributee's interest in the partnership reduced by any cash received in the same distribution.[69] Therefore, if the remaining basis of the distributee's interest is zero, the basis of the distributed property in his hands becomes zero. For example, A receives $10,000 in cash and property having a partnership basis of $5,000. His partnership interest is $8,000. Since his interest is eliminated by the cash distribution, his basis for the property received is zero. In addition he has a $2,000 gain (the excess of the cash over his basis before the distribution).

In a complete liquidation, a substituted basis rule is followed. The basis of the distributed property is an amount equal to the basis of the partner's partnership interest reduced by any money distributed in the same transaction.[70] That is, the distributed properties are allocated over the distributee's interest in the partnership after it has been reduced by any cash received.[71]

An allocation of basis is also made in the case of a current or partially liquidating distribution, where the bases of the distributed properties exceed the basis of the distributee's interest in the partnership.[72]

When an allocation is required in either a current or liquidating distribution, Section 732(c) provides the order in which the allocation is made. The distributee's interest in the partnership is first applied to any unrealized receivables and inventory;[73] but these items cannot take higher bases in the hands of the distributee than they had in the partnership immediately before the distribution.[74] If the distributee's basis is less than the total bases of the unrealized receivables and inventory, the allocation is made in proportion to the bases of such items in the hands of the partnership.[75] Any portion of the distributee's basis which is not applied to the receivables and inventory is then allocated to the other distributed properties.[76] This final allocation is made in proportion to the respective bases of the properties in the hands of the partnership. Where only unrealized receivables or inventory is distributed in a liquidating distribution, that part of the distributee's basis not allocated to such property gives the distributee a capital loss.

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[66] Senate Report No. 1622 83d Congress 2d Session (1954), page 395.

[67] 1954 IRC § 731(b).

[68] 1954 IRC § 732(a)(1).

[69] 1954 IRC § 732(a)(2).

[70] 1954 IRC § 732(b).

[71] 1954 IRC § 732(c).

[72] *Ibid.*

[73] 1954 IRC § 732(c)(1). The definition of inventory is covered by Section 751(d)(2). See footnote 60, above.

[74] 1954 IRC § 732(c)(1). It should be noted here that in a complete liquidation, the bases of distributed property other than unrealized receivables and inventory are not similarly restricted to the bases the items had in the hands of partnership.

[75] 1954 IRC § 732(c)(1).

Here is how one allocation problem would be worked out. For example, the basis of A's partnership interest is $10,000. The partnership distributes the following to him: Cash $4,000; Inventory with a basis to the partnership of $5,000; property X with a partnership basis of $2,000; and property Y with a partnership basis of $4,000. The cash reduces A's basis from $10,000 to $6,000. The $5,000 inventory further cuts it to $1,000. This remaining amount is less than the partnership basis for properties X and Y. So, it is allocated to these properties in the same proportion as their bases in the partnership bear to each other: Property X gets a basis of $333.33 and Y a basis of $666.67. A's basis for his partnership interest is completely wiped out. Any further distribution of property to him would take a zero basis in his hands.

Where a distribution is made within two years after the distributee partner acquired his interest by a transfer, he can take advantage of unrealized appreciation in the distributed property which was reflected in his original partnership investment. He can elect to treat as the basis to the partnership of the distributed property his own basis for the part of his partnership interest (acquired by transfer) that is attributable to such property.[77]

For example, the basis of A's partnership interest is $20,000. He receives a distribution in complete liquidation of his interest as follows: (1) $5,000 in cash, (2) inventory with a partnership basis of $3,000, (3) property X, a capital asset, with a $4,000 basis, (4) and property Y, a depreciable asset, with a basis of $1,000. When A acquired his interest a year ago, the inventory had appreciated and it was worth $20,000. $10,000 of his capital investment was attributed to that value. At the time of the distribution, since 50 per cent of the inventory is still owned by the partnership, $5,000 (50 per cent of the $10,000) can be attributed to his interest in the inventory. Therefore, A can elect to figure the bases of his distributed property this way: His partnership basis of $20,000 less $5,000 cash received, or $15,000, is allocated first to $5,000 inventory. This leaves $10,000 to be spread over the properties X and Y according to their respective bases to the partnership, or $8,000 to X and $2,000 to Y.

Section 732(d) states that this computation may be required where a distribution is made after the two-year limit if the fair market value of all partnership property exceeds 110 per cent of its adjusted basis to the partnership at the time of the transfer.[78]

c. How the disposition of distributed property is taxed. The character of the gain or loss realized by a partner on his disposition of distributed property is the same as would be realized by the partnership if it had made the disposal. That is, where the sale of property would be treated as ordinary income if made by the partnership, the sale of that property by the distributee is also treated as ordinary income. So where a partner receives a distribution of unrealized receivables, any gain or loss realized when he sells these is ordinary gain or loss.[79] The same rule holds for the disposition of inventory—unless it is sold after the distributee has held it for more than five years.[80] In that case, he would realize capital gain or loss.

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[76] 1954 IRC § 732(c)(2).

[77] 1954 IRC § 732(d). This election is made by the distributee partner and it can only be made where the partnership has not made an election under Section 754 to adjust the basis at the time he acquired his interest. If this election had been made, the distributee would already have a special basis adjustment under Section 743(b). See Section 5 of this chapter.

[78] Proposed Regulations indicate that this provision is elective, not mandatory. Prop. Inc. Tax Reg. (1954) § 1.732-1(d).

In computing the holding period for distributed property, the distributee can include the time the property was held by the partnership.[81] However, this rule does not apply to computing the holding period of inventory items.[82] For inventory items, the holding period starts from the time the partner received the distribution.

d. How the partnership adjusts its basis after a distribution. Under the 1939 Code, where a partner received a basis for distributed property differing from its partnership basis, a partnership could not adjust the basis of its remaining property to reflect this difference. The 1954 Code alleviates this inequity. So, for example, where property with a partnership basis of $5,000 is distributed to a partner who has to take it at a basis of $4,000, the assets remaining in the partnership can be increased to take up the $1,000 loss in basis to the distributee. This section will have its greatest effect in a complete liquidation of a partnership interest where [via Section 732(b)] the distributee is given a substituted basis which, in most cases, creates a difference between the partnership's basis for the property and the distributee's basis.

To make these adjustments, an election under Section 754 must be filed.[83] Once the election is made it applies to all property transfers until revoked.[84] The partnership which makes an election adds to the basis of its remaining assets:

1. Any gain recognized to distributee.[85] This would cover a case under Section 731(a)(1) where the distributed cash exceeds the partner's interest.
2. The excess of the adjusted basis of the distributed property to the partnership immediately before the distribution over the basis it has to the distributee.[86] For example, property with a basis of $15,000 is distributed to a partner whose interest in the partnership is $10,000. Under the election, the partnership can increase the basis of the remaining assets by $5,000 for the partner's $5,000 loss of basis.

However, an election may work to the detriment of the partnership. An electing partnership is required to decrease the basis of its remaining assets by:

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[79] 1954 IRC § 735(a)(1).
[80] 1954 IRC § 735(a)(2).
[81] 1954 IRC § 735(b).
[82] *Ibid.*
[83] 1954 IRC § 735(a).
[84] Examples of circumstances under which an election may be revoked are indicated in Proposed Regulations. They include: a change in the nature of the partnership business; a substantial increase in the assets of the partnership; a change in the character of the partnership assets, or an increased frequency of retirements or shifts of partnership interests. Prop. Inc. Tax Reg. (1954) § 1.754-1(c).
[85] 1954 IRC § 734(b)(1)(A).
[86] 1954 IRC § 734(b)(1)(B).

1. Any loss recognized by the distributee under Section 732(a).[87] That is, where in a complete liquidation, only money and unrealized receivables and/or inventory were distributed and these exceed the distributee's partnership interest.

2. The excess of the basis of distributed property to the distributee over the basis of the distributed property to the partnership immediately before the distribution.[88] This rule covers only distributions in complete liquidations. For example, A's partnership interest is $10,000. He receives, in a complete liquidation, property X with a partnership basis of $1,000, and Y with a partnership basis of $4,000. The basis of X to A is $2,000 and of Y, $8,000. To account for this $5,000 increase of bases to A, the partnership would have to decrease the bases of its remaining assets by $5,000.

The methods of allocating these increase or decrease adjustments are provided for by Section 755. An adjustment is made only to the remaining property similar in character to the distributed property which has created the adjustment.[89] And it must have an effect of reducing the differences between the fair market value and the adjusted basis of the remaining property.[90] Therefore, where an increase adjustment is allocated, the adjustment is spread only to those assets whose market values are more than their adjusted bases in proportion to the differences between the value and basis of each.[91] No adjustment is made where the property's basis is more than its market value because the adjustment would increase rather than reduce the difference between its market value and basis.

The basis of any property cannot be reduced below zero.[92] So, where a decrease adjustment is greater than the basis, the basis of such property is reduced to zero and the balance of the adjustment is applied against property of a similar character acquired later on.[93]

e. Distributions where there is unrealized receivables on appreciated inventory. Section 751 encompasses a new phase in partnership law. Striking at the collapsible partnership loophole, it hits at those dispositions of partnership property which would otherwise permit a partner to avoid reporting his share of ordinary income which would be reflected in the normal course of a partnership's sale of inventory and the collection of accounts. Section 751 as it applies to the sale or exchange of a partnership interest has been covered in Section 4 of this chapter. This section covers its effect on partnership distributions under Section 751(b).

The influence of Section 751(b) must be reckoned with whenever a partnership holds unrealized receivables[94] and substantially appreciated inventory.[95]

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[87] 1954 IRC § 734(b)(2)(A).

[88] 1954 IRC § 734(b)(2)(B).

[89] 1954 IRC § 755(b).

[90] 1954 IRC § 755(a)(1).

[91] Section 755(a)(2) permits any other manner of allocation allowed by regulations. See Prop. Inc. Tax Reg. (1954) § 1.755.

[92] 1954 IRC § 755(b).

[93] *Ibid.*

[94] Section 751(c) defines "unrealized receivables" as including "to the extent not previously includable in income under the method of accounting used by the partnership any rights (contractual or otherwise) to payment for—

(1) goods delivered, or to be delivered to the extent the proceeds therefore would be treated as amounts received from the sale or exchange of property other than a capital asset or

Where a partnership has none of these items, a distribution is not within its scope. But where these assets are held, 751(b)'s effect must be considered. And in this respect, it is important to watch these three aspects of the problem.

1. Section 751(b) covers not only the distribution of unrealized receivables and appreciated inventory but also the distribution of other types of assets as well—for example, the distribution of capital assets or Section 1231 assets. Thus, where a partner receives in a complete liquidation only capital assets or Section 1231 assets (or both) and not his share of unrealized receivables or appreciation inventory or both, he is avoiding an ordinary income tax on his interest in the latter assets.[96] That is, in effect, he has sold to the partnership his interest in the receivables or the inventory measured by the amount he has relinquished of this interest in exchange for that part of the capital assets which is in excess of his proportionate share in these assets. On the exchange, he realizes ordinary income for the difference between the basis allocated to his interest in the unrealized receivables or inventory, and the value of the capital assets received in exchange. The partnership has capital gain for the difference between the basis allocated to the distributed property in excess of the distributee's proportionate share and the value of the interest in unrealized receivables or inventory relinquished by him.

2. The nondistributee partners can realize ordinary income when a distributee, in a complete liquidation picks up more than his share of unrealized receivables and inventory.[97] This kind of transaction, in effect, would allow the nondistributees to avoid an ordinary income tax on their share of these assets and to set up a later sale of the remaining assets at capital gain rates. Section 751(b)(1)(A) prevents this result. The partnership realizes ordinary income for the difference between the basis of receivables and inventory allocated to the disproportionate part of the distribution and the value of the distributee's interest in the other assets of the partnership given up in the exchange for the unrealized receivables and inventory. The distributee realizes capital gain to the extent that the value of the unrealized receivables and inventory received by him in excess of his share exceeds the basis allocated to his interest in the other property given up in the exchange.

3. Even though a partnership holds appreciated inventory or unrealized receivables or both, if a distribution reflects the distributee's proportionate share in the assets, no tax will result.[98] The operation of Section 751(b) involves the tacit assumption that a partner owns a proportionate share in each of the assets held by the partnership. So, when he receives more than his proportionate interest in a type of asset, he relinquishes his rights in the property remaining in the partnership. And this *quid pro quo* results in a taxable exchange.

There is no question that the operation of Section 751(b) applies to a liquidating distribution where a definite interest is relinquished. However, its application to a current distribution is doubtful where there is no evidence that the

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(2) services rendered or to be rendered."

[95] Appreciated inventory under Section 751(d)(1) is defined as inventory whose fair market value exceeds:
(1) 120 per cent of its adjusted basis to the partnership and
(2) 10 per cent of fair market value of all partnership property.

[96] 1954 IRC § 751(b)(1)(B).

[97] 1954 IRC § 751(b)(1)(A).

[98] House Report No. 2543, 83d Congress, 2d Session (1954), page 65.

distributee has given up any of his original interest in any of the partnership property. Though it may be inferred that when a partner gets a disproportionate share in one type of asset, he has proportionately cut his interest in another type.[99]

There are two exceptions to the operation of Section 751(b)(1):

1. When a distributee gets a distribution of property which he originally contributed to the partnership;[100]
2. When payments are made to a retiring partner or deceased partner's successor in interest of unrealized receivables.[101] The latter payments are taxed as ordinary income under Section 736(a).[102] However, payments covering appreciated inventory are covered by Section 751(a) (Section 4 of this chapter).

7. When a Partnership Terminates

The new Code sets out specific rules regarding the termination of partnerships.[103] Inasmuch as the criteria set forth in the law are the only tests for determining whether or not a partnership has terminated, knowledge of these rules becomes extremely important. For example, a partnership might terminate under these rules without the partners being aware of that and a new partnership formed. Unaware of the fact that they have a new partnership, the partners might lose out on many of the elections available to a new partnership in its first tax return. Furthermore, an unexpected termination might create the pyramiding of more than one year's partnership income in one taxable year of the partners. Termination of a partnership ends its tax year,[104] requiring the partner to pick up his share of the income for that partnership tax year in his own tax year in which the termination took place.[105] If the otherwise normal tax year of the partnership has already ended within that same tax year of the partner, a pyramiding of more than 12 months' partnership income occurs.[106]

The rules for termination, as set forth in the new Code, seem simple enough. Their application, however, may prove to be far from a simple matter. Before considering the complications of the application of these rules, the rules themselves should be examined.

The first rule is that a partnership is to be considered as continuing unless it is terminated.[107] The next rule, the termination rule, divides into two parts.

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[99] See Paul Little, "Partnership Distributions Under the Internal Revenue Code of 1954," *Tax Law Review*, January 1955, Vol. 10, pages 187-189, for an excellent discussion of this point. See also Prop. Inc. Tax Reg. (1954) § 1.751-1(b)(1) and (2) which talks of current distributions as also falling within the scope of Section 751(b).

[100] 1954 IRC § 751(b)(2)(A).

[101] 1954 IRC § 751(b)(2)(B).

[102] Footnote 64, above.

[103] 1954 IRC § 708.

[104] 1954 IRC § 706(c); Senate Report No. 1622, 83d Congress, 2d Session (1954), page 386.

[105] See Section 2(d) of this chapter.

[106] For example, assume Partnership AB's fiscal year ends January 31, 1955. On December 31, 1955 the partnership terminates under the rules of Section 708. Partner A, reporting on a calendar year basis, would have to report in his 1955 personal tax return his share of the partnership income for the year ended January 31, 1955 and for the year ended December 31, 1955. Thus his share of 23 months' partnership income would all be reportable in one taxable year.

[107] 1954 IRC § 708(a).

A partnership is considered terminated, when, either:

1. No part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership,[108] or
2. Within a 12-month period there is a sale or exchange of 50 per cent or more of the total interest in partnership capital and profits.[109]

In addition to the above termination rule, there are two special rules covering mergers or consolidations of partnerships and divisions of partnerships. (1) Where two or more partnerships are merged, the new partnership is considered the continuation of any partnership in existence before the merger whose partners own an interest of more than 50 per cent in the capital and profits of the new partnership.[110] (2) Where a partnership is divided into two or more new partnerships, any new partnership whose partners owned an interest of more than 50 per cent in the old partnership's capital and profits is considered a continuation of the old partnership.[111]

Various problems are raised in attempting to apply the rules of Section 708 to actual situations. The answers to most of these problems will probably have to await the issuance of the Commissioner's regulations, and many will probably not be answered until they are subjected to considerable litigation.[112]

Several problems present themselves in connection with the sale or exchange of more than 50 per cent of the partnership interest. First, there is a question of whether certain transactions constitute exchanges. It is quite clear, for example, that transfers by gift or on the death of a partner are not exchanges.[113] However, we have no clear indication as to whether or not there is an exchange when a liquidating distribution is paid to a partner or when a new partner is admitted to the partnership.

Further complications present themselves in connection with the sale or exchange rule when the 50 per cent aspect of that rule is to be applied. It is to be noted that the statute refers to "50 per cent or more of the total interest in partnership capital *and* profits" (emphasis supplied). Had the statute read "or" rather than "and," the rule would be easier to apply.[114] However, how do we arrive at the total of capital and profits to be able to apply the 50 per cent rule to that total? For example, as much as 100 per cent of either capital or profits might be less than 50 per cent of the total of the two.[115] Furthermore, other questions arise concerning the computation of the 50 per cent. Assume less than 50 per cent is sold and then, within a 12-month period, a new partner is admitted (with a new capital contribution). Subsequently, but still within the 12-month period, another sale of a partnership interest is made. Which 100 per cent figure is used to determine whether more than 50 per cent was sold—the 100 per cent figure at the time of the first sale or at the time of the second sale (after the intervening admission of a new partner and a reshuffling of the capital and profit sharing arrangement)? [116]

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[108] 1954 IRC § 708(b)(1)(A).

[109] 1954 IRC § 708(b)(1)(B).

[110] 1954 IRC § 708(b)(2)(A).

[111] 1954 IRC § 708(b)(2)(B).

[112] For a detailed exposition of the problems involved in this area and some suggested solutions, see Paul Little, "Partnership Terminations and Reorganizations," *Proceedings of New York University Thirteenth Annual Institute on Federal Taxation,* pages 897-920, New York: Matthew Bender and Company, 1955.

[113] House Report No. 2543 (The Conference Committee Report), 83d Congress, 2d Session (1954), page 61.

[114] That "and" and not "or" was intended can be seen from The Conference Committee Report. House Report No. 2543, 83d Congress, 2d Session (1954), page 61.

[115] Proposed Regulations indicate that 50 per cent of both capital and profits must be sold or exchanged. For example, a sale of 30 per cent interest in capital and a 60 per cent interest in profits is not deemed to meet the 50 per cent rule. Prop. Inc. Tax Reg. (1954) § 1.708-1(b)(1)(ii).

Other questions arise in the areas already discussed as well as in the application of the merger and division rules at the same time as the sale and exchange rule. Many variations and complications can be envisioned in this area. But, as previously noted, the answers await further clarification via regulations and litigated cases.

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[116] Proposed Regulations do not cover this point. They merely indicate that if in Partnership ABC, A sold a 30 per cent interest in profits and capital to D on May 12, 1956 and B sold a similar 30 per cent interest to E on March 27, 1957, the partnership would be considered terminated on March 27, 1957. Prop. Inc. Tax Reg. (1954) § 1.708-1(b)(1)(ii).

4

How to Organize and Operate a Tax-Exempt Company

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The number of organizations claiming tax exemption under 1954 IRC § 501 (1939 IRC § 101) has increased steadily over the past ten years. Originally devoted to religious, educational, or philanthropic activities, they have gradually spread into all areas of the community to the point where today, business and labor groups, title holding companies, building and loan associations, co-operatives, charitable trusts, and foundations grossing billions of dollars from business operations are granted the privilege of Federal income tax exemption as nonprofit organizations.

Sections 501 and 521 of the 1954 code (1939 IRC § 101) contain 18 subsections which outline the types of organizations that are entitled to the tax-exemption privilege because they are engaged in religious, educational, or philanthropic endeavors for the general or mutual welfare of the entire community, and not organized or operated for purposes of profit or gain to any private member or shareholder. An additional general requirement for tax exemption is that such an organization must not engage in any activities serving to influence legislation.

In 1950 and 1951 the Congress adopted certain changes in the Internal Revenue Code with the view to limiting the tax-free status of such nonprofit organizations.

A nonprofit organization does not receive the benefits of tax-exempt status automatically. In order to establish its exemption status, the organization is required to file with the Director of Internal Revenue its exemption application or affidavit on printed forms to be obtained from the Director outlining the character of the association, its objectives, its actual activities, the sources of its income, and the disposition of its income. The mere contention by an organization that it is exempt from income taxation under 1954 IRC § 501; 1939 IRC § 101 does not relieve it from filing income tax returns and paying the tax. The Commissioner of Internal Revenue will examine the completed exemption application as filed by each organization and will then advise the organization of his determination. If the Commissioner rules that the organization is tax-exempt, no further income tax returns will be required.

1. Points to Consider

Perusal of the 17 subsections of 1954 IRC § 501 and 1954 IRC § 521 (1939 IRC § 101) must be made to determine the specific subsection under which the company's activities might qualify. The revenue code will indicate the limitations of association activities and the limitations of the disposition of its income.

	Section
What are the limitations placed on its method of operation?	Discussed under each subsection of 1954 IRC, in section 2 of this chapter.
What are the limitations placed on its disposition of income?	
Check list of organizations granted or denied exemption	

Assuming it is then intended to proceed with the organization, the following problems arise:

	Section
What form of organization should be used?	3
What provisions should be incorporated in its charter?	4
How does it proceed to obtain its exemption?	5
With what further procedures must it comply?	6
What recourse is there if exemption is not granted?	7
Does the statute of limitations protect exempt organizations?	8

2. Classes of Exempt Organizations

The following summarizes the various classes of nonprofit organizations:

Subsection 1954 IRC	Subsection of 1939 IRC 101	Class of Organization	General Nature of Activities
501(c)(1)	15	Corporation organized under an act of Congress	Instrumentalities of the United States.
501(c)(2)	14	Title holding corporations	Holding title to property of an exempt organization.
501(c)(3)	6	Religious, charitable, scientific, literary, and educational associations	Activities of nature implied by description of class of organization.[1]
501(c)(4)	8	Civic leagues (a); local associations of employees (b)	(a) Promotion of community welfare; (b) Charitable, educational or recreational.[2]
501(c)(5)	1	Labor, agricultural, or horticultural organizations	Educational or instructive, the purpose being to improve contions of work, and to improve products and efficiency.[3]
501(c)(6)	7	Business leagues, chambers of commerce, real estate boards, boards of trade	Improvement of business conditions of one or more lines of business.[4]
501(c)(7)	9	Social clubs	Pleasure, recreation; social activities.[5]

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[1] Reg. 118, § 39.101(6)-1
[2] Reg. 118, § 39.101(8)-1
[3] Reg. 118, § 39.101(1)-1
[4] Reg. 118, § 39.101(7)-1
[5] Reg. 118, § 39.101(9)-1

Subsection 1954 IRC	Subsection of 1939 IRC 101	Class of Organization	General Nature of Activities
501(c)(8)	3	Fraternal beneficiary societies	Lodge providing for payment of life, sickness, accident, or other benefits to members.[6]
501(c)(9)	16	Voluntary employees' beneficiary associations	Providing for payment of life, sickness, accident, or other benefits to members.
501(c)(10)	19	Voluntary beneficiary association of U.S. Government employees	U.S. Government employees' association providing for payment of life, sickness, accident, or other benefits to members.
501(c)(11)	17	Teachers' retirement fund associations	Teachers' association for payment of retirement benefits.
501(c)(12)	10	Local benevolent life insurance associations, mutual irrigation, and telephone companies, and similar organizations	Activities of a mutually beneficial nature similar to those implied by the description of class of organization.[7]
501(c)(13)	5	Cemetery companies	Burials and incidental activities.[8]
501(c)(14)	4	Building and loan associations; cooperative banks; credit unions	Loans to members. Exemption as to building and loan associations and cooperative banks repealed by Revenue Act of 1951, affecting all years after 1951.[9]
501(c)(15)	11	Mutual insurance companies	Providing insurance to members substantially at cost.[10]
501(c)(16)	13	Crop financing corporations	Financing crop operations in conjunction with activities of a marketing or purchasing association.[11]
501(d)	18	Religious or apostolic associations or corporations	Regular business activities.
521	12	Farmers' cooperative marketing and purchasing associations.	Cooperative marketing and purchasing for agricultural producers. Exemption as to farm cooperatives repealed by Revenue Act of 1951 affecting all years after 1951.[12]
—	2	Mutual savings banks	This exemption repealed by Revenue Act of 1951, affecting all years after 1951.

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[6] Reg. 118, § 39.101(3)-1
[7] Reg. 118, § 39.101(10)-1
[8] Reg. 118, § 39.101(5)-1
[9] Reg. 118, § 39.101(4)-1
[10] G.C.M. 25497, 1948-1 C.B. 60.
[11] Reg. 118, § 39.101(13)-1
[12] Reg. 118, § 39.101(12)-1

The numerous types of tax-exempt organizations and the different standards of exemption make it advisable to discuss each question under its specific subsection of the code.

Summary of Revenue Acts of 1950 and 1951. Prior to the passage of the Revenue Act of 1950, there was no partial tax exemption for a 1939 IRC § 101 organization. Such a corporation was either fully exempt or fully taxable.

In brief, the Revenue Acts of 1950 and 1951 impose an income tax upon those organizations which are exempt under 1954 IRC § 501(c)(2), (3), (5) and (6) (1939 IRC § 101(14), (6), (1) and (7)), the tax itself being levied on their "Unrelated Business Net Income" as well as on their 1954 IRC § 514 (1939 IRC § 423) "Business Leases" Income. The objective of these new revenue acts is to levy a tax on the net income of these organizations from nonrelated trade or business and also to levy a tax on rents from their 1954 IRC § 514 (1939 IRC § 423) "Business Leases," but not on dividends, interest, annuities, or royalties.

If a 1954 IRC § 501 (1939 IRC § 101) exempt organization should now engage in a business enterprise for profit purposes, it is most advisable that a thorough analysis be made of the new restrictive provisions of the Revenue Act of 1950 and the Revenue Act of 1951 that apply to such an organization, as well as 1954 IRC §§ 511, 512, 513, 514, 515 (1939 IRC §§ 421, 422, 423, and 424) in order for such organization to avoid losing its tax-exempt status.

These new restrictive provisions do not impose a universal tax on all "unrelated business income" of exempt organizations of the aforementioned subsections although that would appear to be the situation at first glance. The following exceptions to the 1954 IRC § 511 (1939 Supplement U) Tax should be noted:

1. Before the new tax can be applied, the exempt organization must be one of those exempt under subsection (2), (3), (5) or (6) of 1954 IRC § 501(c) (1939 IRC § 101(14), (6), (1) or (7)).
2. The first $1,000 of "unrelated business income" is exempt, even though 1954 IRC Subchapter F. Part II (1939 IRC Supplement U) Tax does apply in a particular case.
3. Such taxable income must be earned in a trade or business that is carried on "regularly" by the exempt organization.
4. Such taxable income must be from an unrelated business.
5. Even though the business may be classified as unrelated and regularly carried on, such income is not subject to income tax if the work is done without compensation, or if the work is done for the convenience of the members, students, patients, officers, or employees of that organization.

The classification of "unrelated business income" under 1954 IRC § 512 (1939 IRC § 422) does not include such income as dividends, interest, annuities, and royalties. For purposes of these sections the term royalties includes overriding royalties. However, if the exempt organization owns a working interest in a mineral property, and it must bear its share of the development costs, then the income received from such an interest is taxable royalty.

Rental income received from real property, and personal property leased in connection with the realty, is to be excluded from taxation. However, rental

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received from a 1954 IRC § 514 (1939 IRC § 423) "Business Lease" is taxable as "unrelated business income."

All gains or losses from the sale, exchange or other disposition of real or personal property are excluded from "unrelated business income." However, in the case of income arising from the sale of property consisting of the stock in trade of a kind that is inventoriable, or property that is held for sale to customers in the course of an unrelated trade or business, such income is properly taxable.

The following business income is also to be excluded from taxation under 1954 IRC § 512 (1939 IRC § 422):

1. Income of churches, church conventions, and church associations.
2. Income from work under a contract with the federal government or a state government.
3. Income of a college, university, or hospital from research performed for any person.
4. Income from research for the federal government or any of its agencies or instrumentalities, or for a state or political subdivision.
5. All income of an organization operated primarily for the purpose of carrying on fundamental research, provided the results of such research are freely available to the general public.
6. Income from the sale of merchandise, substantially all of which was received by the organization as gifts or contributions.

In addition to the foregoing list of exceptions, particular note should be made of the statutory definition that the nonrelated trade or business must be "regularly" carried on by the organization to effect adversely its tax-exempt status, and that the business must not be "substantially" related thereto.

In computing the "unrelated business net income" of an exempt organization, a deduction is permitted for net operating loss carry-back or carry-over subject to certain specific limitations.

Income from a publishing business carried on by an exempt organization is tax-exempt provided such publishing business becomes related prior to the beginning of the third year following the taxable year.

Before the enactment of the Revenue Act of 1950, the courts had ruled that where a company or organization operated a business for profit and turned over all of its net income to a 1954 IRC § 501 (1939 IRC § 101) exempt organization, the feeder organization was also exempt from income tax. The Revenue Act provides that beginning with January 1, 1951, the business net income (except rental income as limited in 1954 IRC § 514 (1939 IRC § 423)) of the feeder organization whose primary purpose is the carrying on of a business for profit, is taxable even though it pays over all of its net profits to an exempt organization.

Where a college or other exempt organization is engaged in operating several unrelated businesses, it may choose to consolidate all of its businesses under one corporation or it may organize a separate corporation for each business. The latter choice would appear to be preferable, since each such business corporation would be entitled to a $25,000 surtax exemption of its own, thereby resulting in tax savings.

Income that is received by certain exempt organizations from a long-term lease is taxed as "business lease" income in the proportion that any unpaid debt on the rented property at the close of its taxable year bears to the adjusted basis of such property. This provision affects only those exempt organizations which are subject to the 1954 IRC Subchapter F, Part II (1939 IRC Supplement U) Tax on their unrelated business income. A lease will be classified as a "business lease" under the following conditions: (1) where the lease runs for a term of more than five years, or (2) where the same business tenant occupies the property for more than five years even though the property is leased for less than five years. In the second case, the tax will apply only in the sixth and subsequent years in which the tenant occupies the property. The tax will not apply to rental income if the property is leased to several tenants who occupy 50 per cent of the property and have leases for less than five years. Where tenants customarily renew their five-year leases, a new lease may be signed during the last half of the term of the old lease, to take effect at the end of the old lease. The unexpired portion of the first lease will not be treated as a part of the term of the second lease, and the second lease will not be considered to be a lease for more than five years. An option to renew or extend the lease must be counted in determining the term of the lease. For the business lease income to be taxable there must be "business lease indebtedness" against the property. Business lease indebtedness is defined as the debt remaining on the rented property at the close of the taxable year of the lessor organization, either the debt incurred to acquire the property or the debt incurred to improve the property. The exempt organization, however, may be able to avoid the income tax on its business lease income if it can prove that it entered into the business lease for a purpose that is substantially related to its basic exempt functions of charity, education, etc. For example, if an agricultural college borrows $50,000 to purchase a wheat farm and then leases the farm back to the former owner for 50 years and manages to pay the debt with the rental net income, the college may argue that the net profits on the lease are exempt from taxation if the farm is actually used by the college as an experimental farm directly related to the college's primary function as an agricultural institution of learning.

The Internal Security Act of 1950 provides that no organization is entitled to tax exemption under 1954 IRC §§ 501, 521 (1939 IRC § 101), if at any time during any taxable year such organization is registered under Section 7 of the Internal Security Act of 1950, or if the Subversive Activities Control Board issues a final order requiring that organization to register. Contributions to subversive organizations are not deductible.

On September 26, 1953, the Commissioner of Internal Revenue issued Regulations 118 which contain supplemental provisions under Section 39.101 for tax exempt organizations. To the extent that these regulations have not been rendered obsolete by the Internal Revenue Code of 1954 they will be applicable to the new Code.

On August 16, 1954 the President approved Public Law 591, The Internal Revenue Code of 1954. In line with other sweeping revisions of the Code, the provisions affecting tax-exempt organizations were rearranged and consolidated as Subchapter F, Chapter 1, Subtitle A—Income Taxes of the Internal Revenue Code of 1954.

There were few substantive changes made by the new 1954 Code. Changes made affecting the treatment, as "unrelated business income," of certain rental income from business leases are discussed below under the sections to which they apply.

1954 IRC § 501(c)(1). Corporation organized under Act of Congress

A corporation organized under an Act of Congress, that is an instrumentality of the United States is exempt so long as the Congressional Act provides for exemption for that particular corporation.

1954 IRC § 501(c)(2). Title Holding Corporations

Limitations on method of operation. A corporation that is organized for the sole purpose of owning property, collecting all rents therefrom, and disbursing the entire net rental income to a tax-exempt organization may also qualify as an exempt organization. The title holding company may lose its exempt status if it engages in other activities that are not incidental to the upkeep of the property.[13]

The Revenue Act of 1950 created a tax on the "unrelated" business income of organizations that are otherwise exempt under this subsection. Its unrelated business income is taxable under 1954 IRC Subchapter F. Part II (1939 IRC Supplement U) even if its income is paid to a church or convention of churches.

Limitation on disposition of income. The Code specifically provides that all net income must be paid to an exempt organization.

Check list of organizations granted or denied exemption. Exemption was denied to a title holding company operating a public utility, even though all of its stock was held by an exempt company.[14]

Exemption was denied to a cooperative store that was managed by a university where the store sold supplies to the students and all the property reverted to the university.[15]

For a detailed list of those business activities that may be excluded from taxation as "unrelated business income" see the author's summary of Revenue Acts of 1950 and 1951 appearing in Section 2 of this chapter.

1954 IRC § 501(c)(3). Religious, charitable, scientific, literary, and educational organizations

Limitations on method of operation. To receive the privilege of tax exemption, under 1954 IRC § 501(c)(3) (1939 IRC § 101(6)), an organization must meet the following three tests:

1. It must be organized and operated exclusively for one or more of the specified purposes: Religious, charitable, scientific, literary, educational, or for the prevention of cruelty to children or animals.

2. Its net income must not inure in whole or in part to the benefit of private shareholders or individuals.

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[13] I.T. 2436, VII-2 C.B. 147.

[14] *Sand Springs Railway Company*, 21 B.T.A. 1291 (1931).

[15] *Stanford University Book Store*, 29 B.T.A. 1280 (1934), affirmed (D.C. Cir. 1936) 83 F. 2d 710, 17 AFTR 1178.

3. It must not, by any substantial part of its activities, attempt to influence legislation by propaganda or otherwise.

The Revenue Act of 1950; 1954 IRC § 503 brought new standards of operations for certain tax-exempt organizations. These new standards do not apply to religious organizations, educational organizations, government or publicly supported organizations, or to organizations providing medical care, education, or research. The other organizations that are exempt under this subsection—namely, corporations and community chests which are organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes—are prohibited from engaging in the following transactions with certain individuals after July 1, 1950:

1. Lending income or corpus without adequate collateral and reasonable interest.
2. Taking excessive compensation for services rendered.
3. Making services available on a preferential basis.
4. Buying property for more than adequate consideration.
5. Selling property for less than adequate consideration.
6. Engaging in any other transaction which results in a substantial diversion of income or corpus.

The individuals with whom these transactions are prohibited are:

1. A person who has made a substantial contribution to the organization.
2. A member of his family (as defined in 1954 IRC § 267(c)(4) (1939 IRC § 24(a)(2)(d)).
3. A corporation of which 50 per cent or more of its capital stock is owned directly or indirectly by such person.

Violation of any of the above prohibitions may cause an exemption to be withdrawn for future years.

Until the Revenue Act of 1950 was enacted, the limit placed on an exempt organization operating an exempt commercial business was measured by prior rulings of the courts that tax exemption was based upon the final destination of the earnings of the nonprofit organization itself.

For all years after December 31, 1950 the Revenue Act of 1950 amended Section 101 of the 1939 Code to provide that those "feeder organizations" operated for the initial purpose of carrying on a business for profit are taxable even though all its net operating profits are payable to its parent exempt organization.

In addition thereto, the Revenue Act of 1950 provided that in all years beginning after December 31, 1950, organizations exempt from tax under 1939 IRC § 101(14), (6), (1), and (7) [now 1954 IRC § 501(c)(2), (3), (5), and (6)] will be taxable under 1939 IRC Supplement U [now 1954 IRC Subchapter F, Part II] on their "unrelated business net income." [16] Under the Revenue Act of 1950, "unrelated business taxable income" may exist, and yet the organization may still retain its exempt status for other purposes.

The definition of "unrelated business taxable income" can be stated as its total income reduced by applicable deductions which were derived from a business regularly carried on, where the conduct of this same business is substantially not related to the purpose for which the organization was granted the privilege of tax-exemption. The following would not be included as such a business:

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[16] Act § 301(a) adding 1939 IRC §§ 421, 422 and 423; 1954 IRC §§ 511-515.

1. Where personnel do not receive compensation.
2. Where an organization is exempt under 1954 IRC § 501(c)(3) 1939 IRC § 101(6)) and operates a business for the convenience of its members, students, patients, officers, or employees.
3. A business whose sales substantially consist of merchandise received as gifts.

Particularly noteworthy is the fact that the Revenue Acts of 1950 and 1951 did not levy a universal tax on all "unrelated business income" of exempt organizations although that may seem to be the situation at first glance. For a list of those business activities that may be excluded from taxation as "unrelated business income," and coverage on "feeder organization," see the author's summary of the Revenue Acts of 1950 and 1951 earlier in this chapter.

Limitations on disposition of income. Net earnings or any part of net earnings may not inure to the benefit of any private shareholder or individual. In those cases where a trust or an organization is created to administer investments and to disburse to designated parties with the remainder to go to an exempt destination, if any disbursement to individuals is not the dominant reason for the organization's existence then the organization may still be exempt.[17]

It is provided in 1954 IRC § 504 (1939 IRC § 3814) that an organization that has been granted tax exemption may under certain conditions be denied exemption if the funds accumulated from income and not disbursed:

1. Are unreasonable in amount or duration in order to carry out the purpose or function constituting the basis for exemption; or
2. Are used to a substantial degree for purposes or functions other than those for which it was granted exemption; or
3. Are invested in such a manner as to jeopardize the carrying out of the purpose or function which provided the basis for exemption.

Check list of organizations granted or denied exemptions. In *Hultersike Bruder Gernde*, a religious organization was held taxable since its benefits went only to its own group and not to the public.[18]

In *Edward Orton, Jr., Ceramic Foundation*, a scientific foundation under the terms of the will of its founder paid $42,000 and then $350 a month as a life annuity to the widow who thereby relinquished her statutory dower rights. It was held that these payments did not defeat the exemption under this section.[19]

In *Roche's Beach, Inc.* v. *Commissioner*, the court held that a corporation organized and operated exclusively to feed an exempt corporation or trust while not actually disbursing funds for charitable purposes is exempt under this section.[20]

In *Debs Memorial Radio Fund, Inc.* v. *Commissioner*, a taxpayers' association succeeded an unincorporated association organized to conduct a free public radio forum for the dissemination of liberal and progressive social views. It was held not fatal to exemption that substantially all of its income was derived from commercial activities, since the purpose of making profits was to enable the taxpayer to broadcast its educational and cultural programs without charge.[21]

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[17] *Edward Orton, Jr., Ceramic Foundations*, 9 T.C. 533 (1947); but *see Davenport Foundation*, par. 47,341 Prentice-Hall Memorandum T.C. (1947).

[18] 1 B.T.A. 1208 (1925).

[19] 9 T.C. 533 (1947).

[20] 96 F. 2d 776 (1938).

1954 IRC § 501(c)(4). Civic Associations and local associations of employees

Limitations on method of operation. Subsection (4) grants exemption to civic leagues or organizations that are organized and operated not for profit but exclusively for the promotion of social welfare. The organization must benefit the entire community and promote the welfare of mankind. Although the subsection does not specifically prohibit propaganda activities by such an association, the Treasury Department will invoke the same restrictions that apply to organizations exempt under 1954 IRC § 501(c)(3) (1939 IRC § 101(6)).

It is also provided in the 1954 IRC § 501(c)(4) (1939 IRC § 101(8)) for exemption to local associations of employees, whose membership is limited to the employees of a designated person or persons in a particular community, provided its net income is used exclusively for charitable, educational or recreational purposes. The regulations define a local association as one whose activities are limited to a particular community, place or district, irrespective of political subdivisions.

Limitations on disposition of income. Generally, a civic association is restricted in its activities by the same limitations that apply to an educational organization under 1954 IRC § 501(c)(3) (1939 IRC § 101(6)). More and more frequently, the executive director of a civic association or a taxpayers' association asks, "How can I assure prospective donors that their subscriptions, donations or dues are deductible on their federal income tax returns?" Civic associations have usually found that it is important for them to qualify officially with the Treasury Department as a tax-exempt association if they are to raise their required funds. The civic organization may usually attempt to qualify as one of these three types: An educational organization, a business association, or a civic association. In order to qualify as an exempt organization under this subsection the organization must meet the basic requirement of organizations formed under 1954 IRC § 501(c)(3) (1939 IRC § 101(6)).

Can a civic organization distribute controversial literature on legislation and yet retain its exempt status and assure donors that they may deduct their subscriptions on their income tax returns?

Check list of organizations. According to 1954 IRC § 162 (1939 IRC §23(a)) the donor may deduct his subscriptions to such an association "as an ordinary and necessary expense paid or incurred during the taxable year in carrying on his trade or business," provided the donor is in business.

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[21] 148 F. 2d 948 (1945).

The following cases are also cited as bearing upon 1954 IRC § 501(c)(3) (1939 IRC § 101(6)) organizations:

Trinidad v. *Sagrada Orden De Predicadores* 263 U.S. 587 (1924)
Sun Herald Corporation v. *Duggan* 73 F. 2d 298 (1935)
Emerit E. Baker, Inc. 40 B.T.A. 555 (1939)
Scholarship Endowment Foundation v. *Nicholas* 25 F. Supp. 511 (1938)
Davenport Foundation v. *Comm.* 170 F. 2d 70 (1949)
Universal Oil Products Co. v. *Campbell* 181 F. 2d 451 (1950)
C. F. Mueller Co. v. *Comm.* 190 F. 2d 120 (1951)

In 1945 the Commissioner of Internal Revenue held that:

Contributions or dues paid to the "State of R. Taxpayers Association" by businessmen are deductible if it can be shown that such payments have resulted in a reduction of taxes in connection with the operation of the business or that there is a reasonable expectation that the payments will result in tax benefits to the business commensurate with the amount of the payments.[22] The main object or purpose of the State of R. Taxpayers Association is to bring about, through nonpartisan means, the greatest possible economies in government consistent with efficiency in the collection and expenditure of public funds in the State of R.

In the light of court decisions and the commissioner's rulings we may conclude that a taxpayer may deduct a contribution to a municipal reform organization or to a taxpayers association as an ordinary and necessary business expense only if the following conditions are met:

1. The donor must have a reasonable expectation of business benefit as a result of his contribution to the taxpayers' association.
2. The amount of the contribution must bear some relationship to the benefit derived.
3. The political activities of such an association must be limited to the furnishing of information upon request.
4. Promotion of legislation or opposition to legislation by that association will defeat deductibility of the subscription as an "ordinary and necessary" business expense.

The U.S. Lawn Tennis Association Received tax-exempt status under this subsection.

An organization that furnished homes for working men was granted exemption under this subsection. (64 F. 2d 593.)

A cooperative project distributing TVA electricity to both its members and nonmembers received exempt status. (158 F. 2d 272.)

A corporation that owned and operated a radio station, selling radio time to finance its major activity of spreading liberal and progressive views received exempt status under this subsection. (3 T.C. 949.) This court decision appears to be questionable because of the propaganda activities of the radio station.

1954 IRC § 501(c)(5). Labor, agricultural and horticultural organizations

Limitation on method of operation. 1954 IRC § 501(c)(5) (1939 IRC § 101(1)) and regulations 118 require that no net income may inure to the benefit of any individual members, if the organization is to qualify for tax exemption. In addition thereto, these organizations should be educational and instructive in character and have as their objective the betterment of the condition of those engaged in such pursuits as well as the improvement of the grade of products and the development of a higher degree of efficiency in their respective occupations.

The 1950 Revenue Act taxes "unrelated" business income of organizations otherwise exempt under this subsection. For an explanation of so-called "unrelated business income," see the discussion under section 501(c)(3) above.

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[22] I.T. 3735, 1945 C.B. 89.

Limitations on disposition of income. Although Regulation 118 is quite specific that no net income may inure to the benefit of any member, the courts and treasury rulings have indicated that where certain individuals derive commercial benefits, even though not by direct payment, net income may be considered to have inured. Payments for services rendered, however, do not disqualify an exempt organization.

The Commissioner of Internal Revenue has not rendered a specific ruling as to whether strike or unemployment benefits paid to members constitute net income to union members in a sufficient amount to place labor unions in the nonexempt category. It appears that the Commissioner does not consider such payments as disqualifying the labor union.

Check list of organizations granted or denied exemption. Ordinarily, a labor union is exempt under the above regulations. However, one ruling has denied tax exemption to a corporation owned by a labor union which operated a business for the purpose of affording employment to members of the union, where it was the labor union's practice to pay regular wages to the members employed, and after paying expenses to turn over all profits to the treasury of the union.[23]

A contrary example in this category is that of a corporation which was granted tax-exempt status under the following circumstances: The corporation published a newspaper in the interests of organized labor, accepted no advertisements and received just enough funds from the labor union to cover expenses of publication.[24]

Another example of a taxable entity is a corporation owning and operating a "labor temple" used by labor unions and their members, all of its shares being owned by unions and their members, where the premises were used by the general public.[25]

1954 IRC § 501(c)(6). Business leagues, chambers of commerce, real estate boards or boards of trade

Limitations on method of operation. A business league is defined as an association of persons having some common business interest, the purpose of the business league being to promote such common interest and not to carry on a business regularly for profit. The activities conducted should be directed to the improvement of business conditions within the scope of a line of business. The organization cannot have as its goal the performing of services for individual persons.[26]

Limitations on disposition of income. The regulations as to net income not inuring to the benefit of any person or shareholder in a private status, are the same in this subsection as in other subsections.

Check list of organizations granted or denied exemption. The court held in *American Fisherman's Tuna Boat Assn.* v. *Rogan* that the association was exempt as a business league where it aided members in negotiations with canners, helped in their labor troubles and rendered accounting services. Its purposes were to promote fairness, honesty, and better conditions in the fishing industry.[27]

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[23] O.D. 523, 2 C.B. 211.
[24] S.M. 2558, III-2 C.B. 207.
[25] *Portland Cooperative Labor Temple Assn.*, 39 B.T.A. 450 (1939), acq.
[26] Reg. 118, § 39.101(7)-1.

A contrasting case before the United States Tax Court concerned the Automotive Electric Association,[28] where an association of companies engaged in manufacturing, distributing, and servicing electrical equipment for motor vehicles was denied tax exemption as a business league since its catalogue listed only the products of its members, and the association's function was held to be the advertising of its members.

A wholesale grocer's exchange owned a copyright of three brand names under which groceries were sold to members. It was held to be a taxable organization, since the exchange was organized for the benefit of the particular wholesalers who were members of the organization, and the members received shares of the organization's income which consisted of amounts received for the license and use of copyrighted labels.[29]

The Revenue Acts of 1950 and 1951 tax the "unrelated business taxable income" of organizations that would otherwise be exempt under this section. For a detailed list of those business activities that are not taxed as "unrelated business income" see the summary of the Revenue Acts of 1950 and 1951 appearing earlier in this chapter.

The case of Luther Ely Smith, an attorney, had a number of issues. The one most pertinent under 1954 IRC § 501(c)(6) (1939 IRC § 101)(7)) being the petitioner's contribution of $2,500 to the Missouri Institute for the Administration of Justice. This organization's immediate purpose was the establishment, by constitutional amendment, of a new modified appointive system for selection of judges. The institute devoted its time and funds to circulation of petitions, promoting discussions on the radio and preparing and distributing literature. The taxpayer's purpose in contributing to the institute was the belief that any reform resulting from the adoption of the amendment would benefit the legal profession as a whole. It was believed that more than one-half of the legal profession in St. Louis contributed to the institute.

The petitioner contended that this expenditure was deductible both as an ordinary and necessary expense of his profession and also as a contribution to an organization recognized under the Code as a corporation set up solely for nonprofit, educational purposes. The latter contention was denied, the court holding that the institute was not educational in scope but merely used educational methods to achieve the purpose for which it was organized. The court, however, allowed the deduction as an ordinary and necessary expense of the taxpayer's profession since the petitioner would benefit from the improvement in the selection of judges, and it was ordinary procedure for attorneys to be active in movements that would heighten the standing of their profession.[30]

The Underwriters Laboratories, Inc. was incorporated in October, 1936, its charter stipulating that the activities of the organization should be "for service and not for profit," the laboratory's principal function being the examination, testing, classification, and inspection of devices, systems, and materials with reference to their relation to life, fire, crime, and casualty hazards. This work is usually done as a result of requests from manufacturers only, and the fee for the work performed is not contingent upon the facts of disapproval or approval.

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[27] 51 F. Supp. 933 (1943).

[28] 8 T.C. 894 (1947).

[29] *Wholesale Grocers Exchange, Inc.*, T.C. Memo. Dkt. 3104 (7/18/44).

[30] 3 T.C. 696 (1944).

The organization distributes printed material about its research activities and also publishes periodic bulletins listing the approvals as a result of its tests.

The income of the organization is primarily from fees from testing and fees from label and inspection services. A small amount of income is derived from investments.

The court held that the organization was not primarily exempt since its activities benefited profit-making companies and all its basic activities were geared to making the market for their approved products more widespread.[31]

1954 IRC § 501(c)(7). Pleasure, recreation and social clubs

Limitations on method of operation. Clubs organized and operated exclusively for pleasure, recreation, and other nonprofit purposes are tax exempt under the Revenue Code. Regulations provide for tax-exempt status to apply to all social and recreation clubs that are supported by membership fees, dues, and assessments.[32]

It has been ruled that the term "club" applies to groups having individual members and not to organizations consisting of member clubs. Another requirement is that the organization should have social aspects and its members be organized solely for fraternal reasons.[33]

Activities by the club consisting of food sales,[34] publication sales,[35] and other incidental profit-making activities that will raise funds are permissible if carried on only for the convenience of organization members and their guests.[36]

If the activities of the social club are geared to furnish commercial services to its members at a cost lower than would be paid elsewhere, the club is considered to be operating for profitable purposes.[37]

Limitations on the disposition of income. As under other subsections, no portion of the net earnings may inure to the benefit of a private holder of ownership in the organization.

Check list of organizations granted or denied exemption. Aviation Club of Utah, a tax-exempt social club during 1941, lost its exempt status in 1942 and 1943 when its profits were high due largely to the use of its facilities by nonmembers.[38]

A country club which continually sold parcels of property adjoining its golf course was not granted tax exemption.[39]

A contrasting ruling was in the case of a country club which sold small tracts of land that were not of any use to the club and were only purchased when the entire land was obtained; in this case the sales of land were not detrimental and tax exempt status was granted.[40]

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[31] Reg. 118, § 39.101(9)-1

[32] 46 B.T.A. 464 (1942), affirmed (7 Cir. 1943) 135 F. 2d 371, cert. den. 320 U.S. 756 (1943).

[33] G.C.M. 23688, 1943 C.B. 283.

[34] O.D. 108, 1 C.B. 203.

[35] I.T. 2693, XII-1 C.B. 59.

[36] G.C.M. 9470, X-2 C.B. 162.

[37] G.C.M. 23688, 1943 C.B. 283. *Chattanooga Automobile Club*, 12 T.C. 129 (1940).

[38] S. 958, 1 C.B. 202.

[39] G.C.M. 9470, X-2 C.B. 162.

[40] *Anderson Country Club*, 2 T.C. 1238 (1944), acq.

1954 IRC § 501(c)(8). Fraternal beneficiary societies

Limitations on method of operation. Exemption is granted under 1954 IRC § 501(c)(8) (1939 IRC § 101(3)) to "fraternal beneficiary societies, orders, or associations, (1) operating under the lodge system or for the exclusive benefit of members of a fraternity itself operating under the lodge system; and (2) providing for the payment of life, sickness, accident, or other benefits to the members of such society, order, or association or their dependents."

To "operate under the lodge system," mere provision in the charter and bylaws is insufficient.[41] It is necessary that the organization actively carry on activities under a form of organization that comprises local branches called lodges, chapters, or the like which are chartered by a parent organization and largely self-governing.

To be exempt it is not necessary that the fraternal feature should predominate; it is sufficient if both the fraternal and the benefit features are present.[42]

Limitations on disposition of income. Although there are no explicit limitations in the Code, Regulations, and rulings as to the disposition of income, it is usually deemed proper that net income may be distributed only in the form of benefits to members.

Check list of organizations granted or denied exemption. It should be noted that the fraternal feature is strictly defined. A patriotic organization with fraternal and benefit features was denied exemption where its activities extended beyond the usual scope.[43] In a similar case, the Western Funeral Benefit Association, organized as a fraternal and benevolent association, was denied tax exemption as a fraternal beneficiary society when it failed to prove that it was operated under the lodge system or for the exclusive benefit of members of a fraternity itself operating under the lodge system.[44]

It was held also that an association not organized for fraternal purposes—having neither lodges, ritual, ceremonial, or regalia, and whose members are engaged in numerous and diverse vocations, though employees of one company—is not exempt.[45]

1954 IRC § 501(c)(9). Voluntary employees beneficiary associations

Limitation on method of operation. Exemption by the code is granted to voluntary employees' beneficiary association which provide for the payment of life, sick, accident or other benefits to association members or their designated dependents, if 85 per cent or more of its gross income consists of collections from organization members together with amounts contributed to the association by the employer of the members for the sole purpose of making such payments and meeting expenses.[46] (It should be noted that the limitation of 85 per cent does not apply to net income but to gross income.)[47]

Limitations on disposition of income. Under provisions of the Code no part of the net income must inure to the benefit of any individual, shareholder, or part owner.

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[41] I.T. 1516, I-2 C.B. 180.

[42] I.T. 1516, I-2 C.B. 180.

[43] O.D. 508, 2 C.B. 207.

[44] *Western Funeral Benefit Assn.* v. *Hellmick*, 2 F. 2d 367 (1924).

[45] *Philadelphia and Reading Relief Assn.*, 4 B.T.A. 713 (1926).

[46] 1954 IRC § 501(c)(9); 1939 IRC § 101(16).

[47] I.T. 2705, XII-2 C.B. 67.

1954 IRC § 501(c)(10). Federal employees' organizations

Limitation on method of operation. In 1954 IRC § 501(c)(10) (1939 IRC § 101(19) it is provided that exemption shall be granted to: "Voluntary Employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or their designated beneficiaries, if admission to membership in such association is limited to individuals who are officers or employees of the United States Government."

Limitations on disposition of income. The provision that no part of the net earnings should inure to the benefit of any one private shareholder or individual applies here as well.

1954 IRC § 501(c)(11). Local teachers' retirement fund associations

Limitations on method of operation. These organizations are given an exempt status where their income consists solely of amounts received from public taxation, amounts received from assessments upon teaching salaries of members, and income from their investments.[48]

Limitations on disposition of income. The standard restriction of the Code applies to this subsection in that no part of its net earnings may inure to the benefit of any individual or stockholder.

1954 IRC § 501(c)(12). Local benevolent life insurance associations, mutual ditch or irrigation, and mutual or cooperative telephone companies, and similar organizations

Limits on method of operation. This subsection grants exempt status to the aforementioned organizations, if 85 per cent or more of the income consists of amounts collected from the members for the sole purpose of meeting expenses and losses. Pursuant to Regulation 118, Section 39.101(10)-1, this type of association will not receive exempt status if it issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of insurance, and maintains investments from which more than 15 per cent of its income is derived. The organization, on the other hand, may make assessments for the sole purpose of meeting future losses and expenses provided the balance of such assessments remaining on hand at the close of the year is retained to meet losses and expenses or is returned to members.

The phrase "of a purely local character," which applies to benevolent life insurance associations or to similar associations, is defined as referring to an organization whose business activities are confined to a particular community, place, or district.[49]

Limitations on disposition of income. While the Regulations do not use the phrase that no part of the net income may inure to anyone, the phrase has been applied to this subsection by the Treasury in holding one organization exempt.[50]

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[48] 1954 IRC § 501(c) (11); 1939 IRC § 101(17).

[49] Reg. 118, § 39.101(10)-1(b).

[50] I.T. 3286, 1939-1 C.B. 126.

Check list of organizations granted or denied exemption. Exemption was denied to a mutual irrigation company where it received rent for the use of its surplus water.[51]

Voluntary contributions are not includable in the 85 per cent rule, and so collections on the sale of tickets to a ball for a firemen's protective association were held to be voluntary contributions, the organization being granted tax exemption.[52]

1954 IRC § 501(c)(13). Cemetery companies

Limitations on method of operation. A cemetery company is entitled to exemption under 1954 IRC § 501(c)(13) (1939 IRC § 101(5)) if it is owned by a bona fide cemetery corporation and operated exclusively for the benefit of its members who hold lots for bona fide burial purposes and not for purposes of resale. The corporation must not be operated for profit, and its activities must be restricted solely to burials and other incidental business. The definition of business transactions incidental to burials has been defined as undertaking, florist business, and religious services within the cemetery.[53]

Limitations on disposition of income. No part of the cemetery company's net earnings may inure to the benefit of any shareholder or individual having a private interest in the corporation.

A cemetery is not denied tax exemption if it acquires necessary funds by the following method. Preferred stock is issued entitling stockholders to dividends at a fixed rate, not exceeding the legal rate of interest in the state of incorporation, or 8 per cent annually, whichever is greater. Further provisions must be made in the corporate charter that the stock shall be retired at par when sales provide the necessary funds and any excess funds above the needs for dividends and stock retirement shall be used for the care and improvement of the cemetery property.

Check list of organizations granted or denied exemption. In a situation where a cemetery company issued "land share certificates" in payment for cemetery land, the holders of the certificates receiving one-half the amount realized from the sale of the lots but no interest, the privilege of tax exemption was granted.[54]

In another case, when distributions were made to shareholders from surplus after payment of expenses and after provision for maintenance and reserves, tax exemption was denied to the cemetery company.[55]

1954 IRC § 501(c)(14). Domestic building and loan associations, cooperative banks, and credit unions

Limitations on method of operation. In the years prior to 1952, domestic building and loan associations and cooperative banks that had dealings exclusively with their members could attain a tax-exempt status. However, the Revenue Act of 1951 revoked this exemption. The provisions that affect mutual savings banks in 1939 IRC § 101(2), discussed below, also affect domestic building and loan associations and cooperative banks.

[51] O.D. 318, 1 C.B. 207.

[52] G.C.M. 5921, VIII-1 C.B. 179.

[53] *Forest Lawn Memorial Park Assn., Inc.*, 45 B.T.A. 1091 (1941).

[54] *Commissioner* v. *Kensico Cemetery* (2 Cir. 1938), 96 F. 2d 594, 21 AFTR 143.

[55] *W. Laurel Hill Cemetery Co.* v. *McLaughlin* (D.C. Pa. 1942), 44 F. Supp. 63, 29 AFTR 137.

After 1951, building and loan associations, federal saving and loan associations, and cooperative banks will be defined as "banks" under 1954 IRC § 581 (1939 IRC § 104(A)) and will be subject to income tax but not to excess profits tax. They will be permitted a deduction for dividends paid or credited to the accounts of depositors, as well as for repayments of loans made prior to September 1, 1951 by the United States or its wholly owned agencies or instrumentalities, or by any mutual fund established under state law.

Credit unions without capital stock will retain their tax exemption provided they are organized and operated for mutual purposes and without profit.

The Code requires that the building and loans association must limit its business activities substantially to the making of loans to its members to enable them to erect and acquire residences for their own use and occupancy. This restriction does not entirely prohibit such association from making an occasional loan to a nonmember, so long as this practice does not destroy its mutuality. It is essential that the association be recognized by the State.

Limitations on disposition of income. It is necessary that all members, both borrowing and nonborrowing members, share in the association's net income on a proportionate and fair basis, thereby retaining the association's essential characteristic of mutuality as to net profits.

Check list of organizations granted or denied exemption. The Lilley Building & Loan Company was denied the privilege of exemption, because of its borrowing and lending without reference to the needs of its members.[56]

The Economy Savings & Loan Company was denied tax exemption because it changed the nature of its regular business from making most of its loans to its members to dealing largely with nonmembers.[57]

1954 IRC § 501(c)(15). Mutual insurance companies or associations other than life or marine

Limitations on method of operation. Exemption is granted to mutual insurance companies, other than life or marine (including interinsurers and reciprocal underwriters), provided the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000.

To be a true mutual company, the excess of premiums paid over the actual cost, later ascertained, should be returnable to the policyholder and, on dissolution, the net assets should be distributable among the members. The company may maintain a reasonable reserve for payment of losses and expenses, but the excess must be returnable to members. The issuance of nonassessable policies does not, however, automatically entail loss of exemption.[58]

Limitations on disposition of income. It is inherent in the Code and Regulations, even though not explicitly mentioned, that the income should not be shared by the stockholders.

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[56] *Lilley Building and Loan Co.* v. *Miller*, 280 Fed. 143, 2 AFTR 1652, affirmed (6 Cir. 1922) 285 Fed. 1020, cert. den. 43 Sup. Ct. 702.

[57] *Economy Savings and Loan Co.*, 5 T.C. 543 (1945), affirmed on this issue but reversed on other grounds (6 Cir. 1946), 158 F. 2d 472.

[58] *See* footnote 10, above.

Check list of organizations granted or denied exemption. If the stockholders control the company and the policyholders have no say in the management of the company, and in addition thereto large reserves are built up for expansion purposes, the company is denied tax-exempt status.[59]

Exemption was granted to a mutual insurance company which wrote all policies on the nonassessment plan and operated exclusively for the purpose of providing insurance at cost.[60]

1954 IRC § 501(c)(16). Crop financing corporation

Limitations on method of operation. Corporations organized by cooperatives that are exempt under 1954 IRC § (c)(16) (1939 IRC § 101(13)) or tax-exempt cooperatives formed with the purpose of financing crop operations of such members or producers and functioning with such cooperatives are known as crop financing corporations and enjoy tax-exempt status.

Limitations on disposition of income. The same provisions that apply in the case of 1954 IRC § 521, 522 (1934 IRC § 101(12)) also apply in this section with regard to capital stock, reserve, or surplus.

1954 IRC § 501(d). Religious or apostolic associations or corporations

Religious or apostolic associations or corporations are exempted by 1954 IRC § 501(d) (1939 IRC § 101(18)) if such associations or corporations have a common treasury. They are still exempt even if such associations or corporations engage in business for the common benefit of the members, so long as the members thereof include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the annual net income of the association or corporation. Any amount so included in the gross income of a member shall be treated as a dividend received.

This exemption provision differs from that of other subsections in that a religious or apostolic association or corporation is permitted to engage in business for profit for the benefit of its members; however, the exemption is conditional upon its members including in their gross income (at the time of filing their returns) their share of the net income of the corporation for the taxable year. The association or corporation must file Form 1065 and must attach to the return a statement showing the name and address of each member of the association or corporation and the amount of his distributive share of the net income of the associations or corporation for such year.

1954 IRC § 521. Farmers' cooperative organizations

Limitations on method of operation. Before the enactment of the Revenue Act of 1951 the Code granted exempt status to agricultural associations organized and functioning on a cooperative basis for one of these two purposes: (1) The marketing of farmers' products and the turning back to the farmers the proceeds of their sales less essential marketing expenses or (2) The purchasing of supplies and equipment for the cooperative's members (thereby obtaining a lower cost because of volume buying) and transferring to their members at cost plus essential expenses.

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[59] *Keystone Automobile Club Casualty Co.*, 40 B.T.A. 291 (1939), 42 B.T.A. 356 (1940), affirmed (3 Cir. 1941) 122 F. 2d 886.

[60] *See* footnote 10, above.

In addition thereto, the cooperative was permitted to issue capital stock, but the rate of return could not exceed 8 per cent per annum or the legal rate of interest in the state of incorporation, whichever is the greater.

It is permissible to market the products of nonmembers with the restriction however that the value of products of nonmembers marketed does not exceed the the products of members. Concerning the purchasing of supplies and equipment the restrictions are more severe as to nonmembers, the purchasing for nonmembers being limited to 15 per cent of the value of all its purchases.

The Revenue Act of 1951 continued the income tax exemption granted by 1954 IRC § 521 (1939 IRC § 101(12)(A)) for such organizations but imposes a tax upon earnings which are retained by a farmers' cooperative.

Farmers' cooperative associations include farmers', fruit growers', or like associations organized for either or both of the purposes listed above. Cooperatives organized for other purposes are not exempt under this section.[61]

Limitations on disposition of income. Prior to the enactment of the Revenue Act of 1951, the income of a cooperative was treated as follows:

1. Disbursement of earnings to shareholders as dividends on capital stock was not taxable to exempt cooperatives but was taxable to nonexempt cooperatives.
2. Reserves that were built up through net margins and profits and never allocated to members of the cooperative were not taxable to an exempt organization but taxable to a nonexempt cooperative.
3. Nonoperating income (interest, dividends, rent, etc.) was taxable to the nonexempt cooperatives even though allocated to accounts of patrons, but was not taxable to an exempt cooperative whether or not allocated. All the above guides must be governed by the following rule: distribution of the proceeds must be on a proportionate basis, member and nonmember patrons to be treated alike.

For taxable years beginning after 1951, net earnings which are not disbursed by an exempt cooperative or allocated for disbursement are subject to corporate income tax, but not excess profits tax. The exempt cooperative will no longer be exempt on amounts paid as dividends on capital stock and allocated amounts to patrons which were not derived from patronage (interest, rents, or income from business within the United States). In order for allocated funds of a cooperative, as well as nonpatronage income, to be deductible, the funds should be paid on or before the 15th day of the 9th month following the close of the taxable year.[62]

The dividends paid on capital stock is deductible up to 8 per cent per annum or the legal rate of interest in the state of incorporation, whichever is greater, provided that its bylaws permit payment of such dividends.

The Revenue Act of 1951 also found that the earnings or net margins of cooperatives, which will not be taxed either to the cooperative or the cooperative members, will be the margins on patronage that is paid on the basis of personal rather than business expense purchase items. Since no income tax deduction is allowable to the patron on such expenditures, such items are not taxable. With this exception, funds allocated to the accounts of a patron, or paid in cash or merchandise, will be taxable to the patron, regardless of whether the cooperative is tax exempt or taxable. Reserves that are built up as a result of funds not paid out or allocated will be taxed to the cooperative. All funds disbursed as dividends on ordinary capital stock of an exempt cooperative are taxable to the stockholder only, but in the case of those nonexempt cooperative the tax will be imposed on stockholder and cooperative.

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[61] Reg. 118, § 39.101(12)-1

[62] 1954 IRC § 522(b)(2); 1939 IRC § 101(12)(B).

Check list of organizations granted or denied exemption. The purchase of raw materials and subsequent conversion by a cooperative purchasing association, in order that they may be immediately used by the cooperative's patrons, was approved as that of an exempt organization.[63]

Where profits were placed in reserve funds by an association and these profits were from transactions with nonmembers, and the organization returned to members profits received on dealing with members, exemption was denied.[64]

A cooperative association marketed products bought by members in an amount of which the dollar value exceeded the dollar value of products grown or otherwise produced by members for whose accounts such products were marketed. The limitation placed on business done for nonmembers was violated and the association was denied exemption.[65]

A fruit growers' association was denied exemption because it dealt with nonmembers at a profit, yet purchased supplies for members at cost even though its dealings with nonmembers was only 2 per cent of its total business.[66]

1939 IRC § 101(2). Mutual savings banks

Limitations on method of operation. Prior to 1952, mutual savings banks not having capital stock represented by shares, were tax exempt under 1939 IRC § 101(2).

Under provisions of the Revenue Act of 1951, mutual savings banks will have certain of their earnings from 1952 on, subjected to the tax regulations that govern other banks, with the exception of their enjoying an exempt status insofar as excess profits taxes are concerned.[67]

The 1951 change in the law still affords the mutual savings banks with preferential treatment in that their earnings are governed by deductions or allowances before applying the tax rates in the following areas: (1) bad debt reserves;[68] (2) dividends paid or credited to the accounts of depositors;[69] (3) repayment of certain loans;[70] and (4) life insurance departments.[71]

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[63] S.M. 2288, III-2 C.B. 233.

[64] *Farmers' Mutual Cooperative Creamery of Sioux Center, Iowa,* 33 B.T.A. 117 (1935).
Clover Farm Stores Corporation, 17 T.C. 1265 (1952).
William A. Joplin, Jr., 17 T.C. 1526 (1952).
Colony Farms Cooperative Dairy, Inc., 17 T.C. 688 (1951).

[65] I.T. 3853, 1947-1 C.B. 42.

[66] *Fruit Growers' Supply Co.,* 56 F. 2d 90 (1932).
Cooperative Oil Assn., Inc., 115 F. 2d 666 (1941).

[67] 1954 IRC § 11; 1939 IRC § 104. Reg. 118, § 39.104-2

[68] 1954 IRC § 593; 1939 IRC § 23(k). Reg. 118, § 39.23(k)-5(b)

[69] 1954 IRC § 591; 1939 IRC § 23(r). Reg. 118, § 39.23(r)-1

[70] 1954 IRC § 592; 1939 IRC § 23(dd). Reg. 118, § 39.23(dd)-1

[71] 1954 IRC § 594; 1939 IRC § 110. Reg. 118, § 39.110-1

It should be noted that the mutual savings banks that are subjected to new taxing conditions should re-examine closely their charter, bylaws and the history of their past and present operations. This procedure is important since these banks must file tax returns, and their tax returns will be examined by the Internal Revenue Service. The information returns filed as an exempt corporation will be scrutinized carefully by the Treasury Department, and if a nonexempt status is noted, additional tax assessments may be made.

In July, 1952 the Commissioner of Internal Revenue issued regulations governing mutual savings banks, building and loan associations, savings and loan associations, and cooperative banks.[72] These regulations generally require the following: (1) the new taxpayers will continue to use their regular accounting periods, (2) no net operating loss can be carried forward to future taxable years if that loss originated in years prior to the enactment of the Revenue Act of 1951, nor can any annual net operating loss in its present nonexempt status be reduced by any annual net profit earned while the corporation was tax exempt, and (3) the basis of assets and liabilities must be determined under 1954 IRC Subchapter O (1939 IRC § 113), which is applicable to all other taxpayers, in accordance with the organization's regular method of accounting. This last development has the effect of assets being reduced by depreciation, amortization, or depletion, for years prior to its becoming subject to income tax. There is much confusion regarding this issue due to conflicts between court decisions, legislative committee reports and the Commissioner, which apparently can be resolved only through future litigation.

With regard to the reserve method of bad debts, the regulations distinguish between those institutions having surplus, reserves and undivided profits amounting to less than 12 per cent of their total deposits or withdrawable accounts and those institutions having surplus, reserves and undivided profits amounting to more than 12 per cent of their deposits or withdrawable accounts. For bad debt reserves in excess of 12 per cent, the institution must file an application with the Commissioner to justify the allowance in excess of the 12 per cent limitation.[73]

Mutual savings banks may also deduct from their gross income, repayments which they have made prior to September 1, 1951 of loans by the United States or any agency or instrumentality thereof, or loans by any mutual fund that is established and operated under state law.[74]

If the mutual savings bank operates a life insurance department that is operated apart from other operations, their tax is computed as follows:

(1) A partial tax is computed on its noninsurance income, without giving consideration to any income or deductions from its life insurance department. (2) In addition, a partial tax is computed on the income of its life insurance department, which partial tax is computed in the same way and at rates provided for life insurance companies. It is therefore essential that the bank maintain separate accounting records for its life insurance department.[75]

If mutual savings banks adopt careful policies concerning their actual operations and dividend distributions, they should be able to expand with a low income tax burden, despite the restrictions of the Revenue Act of 1951.

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[72] Reg. 118, § 39.104-2

[73] Reg. 118, § 39.23(k)-5

[74] Reg. 118, § 39.23(dd)-1

[75] Reg. 118, § 39.110

3. Form of Organization to be Used

As a general rule, there are no specific requirements in the Internal Revenue Code with regard to the form of organization to be used by an association that desires to qualify as tax exempt. The terms "corporation" and "association," as used in the Code, are not restrictive. The Code defines the term "corporation" as including associations, insurance companies and joint stock companies.[76] The term "company" includes both corporations and trusts.

However, a few of the subsections do specify the form of organization required or restrictions thereon, as listed below:

Section	Organization Requirements
1954 IRC § 501(c)(8); 1939 IRC § 101(3)	A fraternal beneficiary society must be organized on the basis of a lodge system.
1954 IRC § 501(c)(13); 1939 IRC § 101(5)	A cemetery company may not be organized in the form of a trust. A cemetery company may issue preferred stock if the dividends do not exceed the legal rate of interest in the state of incorporation, or 8 per cent, whichever is the greater. The charter should provide for the earliest retirement of this stock at par.[77]
1954 IRC § 501(c)(14); 1939 IRC § 101(4)	A building and loan association must be organized in accordance with the laws of the United States or of a state or territory. Installment stock is an essential feature of a building and loan association.[78]
1954 IRC § 521; 1939 IRC § 101(12)	A cooperative farm organization with capital stock must comply with these requirements: (a) the dividend rate of such stock should be fixed not to exceed the legal rate of interest in the state of incorporation or 8 per cent, whichever is greater, and (b) substantially all of such stock should be owned by producers who market their products or purchase their supplies and equipment through the association. This does not refer to nonvoting preferred stock, the owners of which are not entitled or permitted to participate directly or indirectly in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends. In every case an association will be required to show that the ownership of its capital stock has been restricted, so far as possible, to actual producers.
1939 IRC § 101(2)	If required by state law, a mutual savings bank must be organized under a state statute. It may have no capital stock represented by shares.

4. Provisions to be Incorporated in the Charter

The initial determination of whether an organization is entitled to exempt status is based upon its charter, its constitution, and its bylaws.[79] Court decisions and Treasury rulings of the past indicate that even if an organization's powers are wider than permitted by the Code, it may be able to retain exemption if it actually did not carry out these wider powers.[80] An organization actually going beyond the power restrictions of the Code in activities, will lose its exemption regardless of its charter or bylaws.[81]

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[76] 1954 IRC § 7701(a)(3); 1939 IRC § 3797(a)(3).

[77] S.M. 2225, III-2 C.B. 211.

[78] I.T. 1881, II-2 C.B. 200.

[79] O.D. 190, 1 C.B. 194.

[80] I.T. 2325, V-2 C.B. 63. *Roche's Beach, Inc.* v. *Commissioner* (2 Cir. 1938), 96 F. 2d 776, 21 AFTR 262; *Debs Memorial Radio Fund, Inc.* v. *Commissioner* (2 Cir. 1945), 148 F. 2d 948, 33 AFTR 1220; I.T. 1914, III-1 C.B. 287.

Therefore, each organization's powers should be restricted by its charter and bylaws to be in agreement with those powers that the Code permits such an exempt organization to have under the applicable subsection of the Code; and its actual activities should also be limited.

5. Procedure for Obtaining Exemption

Each organization desiring a tax-exempt status must file a questionnaire or affidavit with the District Director of Internal Revenue of the district in which it is located. The form to be used by each class of organization is listed below.[82]

Subsection 1954 IRC	Subsection 1939 IRC § 101	Type of Organization	Form to be Used
501(c)(1)	15	U.S. Instrumentalities	Affidavit
501(c)(2)	14	Title Holding Corporations	1026
501(c)(3)	6	Religious, charitable and the like	1023
501(c)(4)	8	Civic leagues and similar groups	1024
501(c)(5)	1	Labor, agricultural, horticultural	1024
501(c)(6)	7	Business leagues	1024
501(c)(7)	9	Social clubs	1025
501(c)(8)	3	Fraternal	1024
501(c)(9)	16	Employees' beneficiary associations	1026
501(c)(10)	19	U.S. Government employees' associations	Affidavit
501(c)(11)	17	Teachers' retirement funds	Affidavit
501(c)(12)	10	Local benevolent life insurance companies and others	1026
501(c)(13)	5	Cemetery companies	Affidavit
501(c)(14)	4	Credit unions	Affidavit
501(c)(15)	11	Mutual insurance companies	Affidavit
501(c)(16)	13	Crop financing corporations	Affidavit
501(d)	18	Religious associations	Affidavit
521	12	Farmers' cooperatives	1028
—	2	Mutual savings banks	Affidavit

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[81] *Apartment Operators' Assn.*, 46 B.T.A. 229 (1942), affirmed (9 Cir. 1943) 136 F. 2d 435, 31 AFTR 174.

[82] Reg. 118, § 39.101-1.

The affidavit, where its filing is required, should include the following information:

1. Character of the organization.
2. Purpose for which it was organized.
3. Its actual activities.
4. Sources and disposition of income.
5. Whether or not any of its income is credited to surplus or may inure to the benefit of any private shareholder or individual.
6. In general, all facts relating to its operations which affect its right to exemption.

Each affidavit or questionnaire should be transmitted together with a copy of the articles of incorporation or other instrument stating the permitted powers or activities of the organization, the bylaws or any other source of permitted powers the organization may possess, and the organization's latest financial statement presenting its assets, liabilities, surplus cash receipts and disbursements.

In the case of a mutual insurance company, there must also be submitted copies of the policies or certificates of membership.

Where a title holding company claims exemption under 1954 IRC § 501(c)(2); (1939 IRC § 101(14)) and the organization for which it holds title has not been ruled exempt by the Treasury, the forms needed to determine the status of the latter organization should be filed.[83]

6. Further Procedures

Every tax-exempt organization, except those which are specifically relieved of this obligation, is required to file an annual return.[84] An organization claiming to be specifically exempted from filing annual returns must submit with and as a part of its application for exemption a statement of all the facts on which it bases its claim.[85] A central organization of affiliated exempt groups may, in addition to filing its own annual return, file a group return for two or more of its local chapters.[86] An organization that has established its right to tax exemption and has also established that it is not required to file annual returns must notify the district Director of Internal Revenue for the district in which it has its principal office, in writing, of any changes in its character, operations, or purpose for which it was originally created.[87]

The following organizations are not required to file annual returns:[88]

1. Religious organizations.
2. Organizations operated, supervised or controlled by or in connection with religious organizations.
3. Educational institutions maintaining a regular faculty and curriculum and

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[83] *See* footnote 82, above.
[84] Reg. 118, § 39.101-1(e).
[85] Reg. 118, § 39.101-1(b)(3).
[86] Reg. 118, § 39.101-1(f).
[87] Reg. 118, § 39.101-1(j).
[88] 1954 IRC § 6033; 1939 IRC § 54(f). Reg. 118, § 39.101-1(h)(1).

having a regularly organized body of pupils in attendance at the place where the educational activities are conducted.

4. Societies for the prevention of cruelty to animals or children supported in whole or in part by governmental contributions, or primarily by contributions from the general public.

5. Fraternal beneficiary societies exempt solely under 1954 IRC § 501(c)(8); 1939 IRC § 101(3).[89]

6. Instrumentalities of the United States.[90]

An educational institution will not be required to file an annual return if it is compelled temporarily to curtail or discontinue its normal activities because of abnormal circumstances.[91]

Organizations required to file annual returns should file on Form 990. Those organizations exempt under 1954 IRC § 501(c)(3); 1939 IRC § 101(6) file Form 990-A in lieu of Form 990. Religious associations exempt under 1954 IRC § 501(d); 1939 IRC § 101(18) file the regular partnership return, Form 1065, instead of Form 990. Farmers' cooperative associations exempt under 1954 IRC § 521; 1939 IRC § 101(12) file Form 990-C for years beginning after December 31, 1951.[92]

In addition to the forms listed above if an exempt organization has unrelated business taxable income in excess of $1,000 such income is to be reported on Form 990-T.[93]

Returns shall be filed on the basis of the established annual accounting period of the organization. Where no such annual accounting period has been established, the returns must be prepared on the basis of the calendar year.[94]

Annual returns on Forms 990 and 990-A are due on the fifteenth day of the fifth month following the close of the annual accounting period.[95] Annual returns of cooperatives on Form 990-C are due on the fifteenth day of the ninth month following the close of the annual accounting period.[96] Religious associations file Form 1065 on the fifteenth day of the fourth month after the close of their accounting year.[97] Returns of "unrelated business taxable income" are filed by corporations on the fifteenth day of the third month following the close of their accounting year.[98] Unincorporated associations return their unrelated business taxable income on the fifteenth day of the fourth month after the close of their accounting year.[99]

Organizations claiming exemption need not file information returns prior to establishment of their exempt status. Should such an organization claim an exemption and not receive a ruling or determination letter prior to the time it must file a return and pay a tax, the organization may request an extension of time for performing these acts.[100]

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[89] Reg. 118, § 39.101-1(h)(2).
[90] *See* footnote 89, above.
[91] Reg. 118, § 39.101-1(h)(3).
[92] *See* footnote 84, above.
[93] Reg. 118, § 39.101-(k).
[94] *See* footnote 84, above.
[95] Reg. 118, § 39.101-1(g).
[96] 1954 IRC § 6072(d).
[97] 1954 IRC § 6072(a); 1939 IRC § 143(c).
[98] 1954 IRC § 6072(b); 1939 IRC § 53(a)(1).
[99] *See* footnote 97, above.

7. Recourse Where Exemption is Not Granted

If a request for tax-exempt status is denied by the Income Tax Unit, the case will be referred to the Chief Counsel for the Internal Revenue Service for review, upon specific request by the organization, if, in the opinion of the Income Tax Unit the circumstances in the case justify such action. Where such referral takes place, the Chief Counsel may permit an oral hearing, if warranted, to determine the exempt status of the organization. All additional statements and arguments that support the claim for exempt status should accompany the organization's request for review. The entire request, with accompanying statements, should be sent to the Commissioner of Internal Revenue (Technical), Special Technical Services Division, Exempt Organizations Branch. The statement of facts must be sworn to by a principal officer of the organization.[101]

If the Internal Revenue Service denies exemption there is no appeal to the courts. An appeal, if it is taken, must be from a determination of a deficiency by the Commissioner.[102]

8. Statute of Limitations

Exempt organizations were not required to file annual returns under the law prior to January 1, 1951. The Commissioner had the right to reverse the ruling of a predecessor as to the tax-exempt status of an organization. Since no returns were filed, the statute of limitations did not start to run and the organization was liable for all prior years.[103]

Under the present law, if an organization determines in good faith that it is an exempt organization and files its appropriate information return, and at a later date the organization is held to be a taxable corporation in the year for which the return was filed, such return shall be deemed sufficient filing to start the running of the statute of limitations.[104]

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[100] Rev. Rul. 54-393, 54-2 C.B. 125.

[101] Mim. 3357, 1937-1 C.B. 100.

[102] S.M. 2538, III-2 C.B. 286.

[103] *Southern Maryland Agricultural Fair Assn.,* 40 B.T.A. 549 (1939).

[104] 1954 IRC § 6501(g)(2).

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Operation of Corporations as Affected by Tax on Personal Holding Companies

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The management of every corporation must give consideration to Part III of Subchapter G of Subtitle A of the Internal Revenue Code of 1954, which imposes a heavy income tax on the undistributed income of personal holding companies.

Beginning with 1954, a separate personal holding company tax return will no longer be required. The income tax return, Form 1120, will undoubtedly continue to require a statement as to whether or not the corporation is a personal holding company. Every closely held corporation should consider this question carefully each year and answer it correctly.

Although the single income tax return required will start the statute of limitations running for both the income tax and the personal holding company tax, the period of limitations for personal holding company tax will be six years, unless the corporation files with its return a schedule setting forth the items of personal holding company income received during the year and the names and addresses of the individuals who owned, directly or indirectly, at any time during the last half of the year, more than 50 per cent in value of the outstanding capital stock of the corporation.[1]

In the great majority of the cases, it will be obvious that the corporation is, or is not, a personal holding company. In some cases, the answer may be doubtful. The result may depend on how the company is conducted and what transactions it or its stockholders enter into during the year.

If the company is a personal holding company, careful attention to its operations is of importance to minimize the heavy tax burden, and if possible, to change the company's status for the future. If the company is in danger of qualifying as a personal holding company, it may be possible through attention to sources of income or changes in stock ownership during the year, to avoid falling within this burdensome classification.

There are, therefore, discussed in the pages following the characteristics of a personal holding company and the considerations to be kept in mind to avoid that classification, or to operate a personal holding company without unnecessary tax burdens, or to terminate that classification.

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[1] 1954 IRC § 6501(f).

1. Points to Consider

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2. When is a Corporation a Personal Holding Company?

Personal holding companies are subject to a special additional income tax, measured by "undistributed personal holding company income," of 75 per cent of the first $2,000 plus 85 per cent of the balance.[2] This almost prohibitive tax can be avoided by the payment of sufficient dividends during the corporation's taxable year or, to a limited extent, shortly thereafter.[3] The purpose of the personal holding company tax is to discourage the creation or maintenance of "incorporated pocketbooks" in which earnings may be accumulated without the burden of individual tax rates, to compel such corporations to distribute dividends so that the stockholders will be taxable thereon in their individual returns, and to make any accumulations of income by a personal holding company, irrespective of purpose or motive, extremely burdensome.[4]

In the great majority of cases, personal holding company status is highly undesirable, even though such corporations are not subject to the tax on accumulated earnings imposed by Section 531. The most distressing situation is that in which it is belatedly discovered that a corporation has been a personal holding company in some prior year, and hence is subject to heavy personal holding company taxes which could have been avoided if dividends had been paid currently and under prior law, where a separate personal holding company tax return was required, was subject to possible penalties for failure to file such return.[5] It therefore behooves the officers of every closely held corporation to study the statutory definition of personal holding company and the special tax imposed on such corporations, and to check the company's status well before the end of each taxable year.

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[2] 1954 IRC § 541. This tax is in addition to all other income taxes on corporations. *Schinebro, Inc.* v. *Commissioner* (2 Cir. 1942), 131 F. 2d 504.

[3] 1954 IRC §§ 545(a), 563.

[4] Reg. 118, § 39.500-1; *Noteman* v. *Welch* (1 Cir. 1939), 108 F. 2d 206; *American Package Corp.* v. *Commissioner* (4 Cir. 1942), 125 F. 2d 413; *Morris Investment Corp.* v. *Commissioner* (3 Cir. 1943), 134 F. 2d 774, cert. den. 320 U.S. 743; *Cedarburg Canning Co.* v. *Commissioner* (7 Cir. 1945), 149 F. 2d 526, 33 AFTR 1404.

Certain special classes of corporations are not subject to the personal holding company classification.[6]

A corporation will be classified as a personal holding company for any year, only if both a stock ownership requirement and a gross income requirement are satisfied for such year.[7]

a. Stock ownership requirement. No corporation is a personal holding company unless at some time during the last half of its taxable year more than 50 per cent in value of its outstanding stock was owned, directly or indirectly, by or for not more than five individuals.[8] For this purpose all forms and classes of outstanding stock are taken into account.[9] Treasury stock does not count.[10] Stock subscribed and paid for does count, even though the stock certificates have not been issued.[11] Debentures or other debt obligations, not classifiable as stock, do not enter into the computation, but debt classified as "stock" on the "thin incorporation" theory would, no doubt, have to be taken into account.[12]

In most cases it will be relatively easy to determine whether or not the stock ownership requirement is satisfied. This requirement will therefore be discussed first. If the stock ownership requirement is not satisfied, the nature of the corporation's gross income is unimportant.

The statute lays down special rules as to the stock which shall be regarded as owned, directly or indirectly, by a stockholder for this purpose.[13] There is, of course, included all stock beneficially owned directly by the particular stockholder. The fact that such stock is held in the name of a nominee or in a brokerage or custodian account, or that transfer to the stockholder's name has not yet been perfected, is immaterial. Stock owned by an individual is included even though the stock is pledged and the individual is insolvent, so long as the creditors have not taken over the stock.[14] But stock owned by a hopelessly insolvent estate is to be attributed to the creditors rather than to the residuary legatees.[15]

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[5] *Hatfried* v. *Commissioner* (3 Cir. 1947), 162 F. 2d 628, 35 AFTR 1496; *Orient Investment & Finance Co., Inc.* v. *Commissioner* (D.C. Cir. 1948), 166 F. 2d 601, 36 AFTR 818; *Hermax Co., Inc.* 11 T.C. 442 (1948), affirmed (3 Cir. 1949) 175 F. 2d 776; *Haywood Lumber and Mining Co.* v. *Commissioner* (2 Cir. 1950), 178 F. 2d 769; *Genessee Valley Gas Co.* v. *Commissioner* (D.C. Cir. 1950), 180 F. 2d 41; *Wm. J. Lemp Brewing Co.* 18 T.C. 586 (1952).

[6] 1954 IRC § 542(c). See also Tax Conventions with the United Kingdom and with Canada, which exempt from personal holding company tax corporations organized under their laws, if during the entire last half of the taxable year, more than 50 per cent in value of the stock was owned by aliens resident in such countries. § 7.33 of T.D. 5206; § 7.525 of T.D. 5569.

[7] 1954 IRC § 542(a); Reg. 118, § 39.501-1

[8] 1954 IRC § 542(a)(2).

[9] Reg. 118, § 39.503(a)-1

[10] Reg. 118, § 39.501-3

[11] *Collateral Equities Trust*, 39 B.T.A. 834 (1939).

[12] *Washmont Corporation* v. *Hendricksen* (9 Cir. 1943), 137 F. 2d 306, 31 AFTR 390.

[13] 1954 IRC § 544.

[14] *Renton Investment Company*, 46 B.T.A. 279 (1942).

[15] *Renton Investment Company* v. *Commissioner* (3 Cir. 1942) 131 F. 2d 330, 30 AFTR 280.

A charitable corporation or trust is treated as an individual stockholder for this purpose.[16]

In addition to stock directly owned, stock is regarded, for this purpose, as indirectly owned by the stockholder in the following situations:

1. He must, under Section 544(a)(1), include his proportionate share of stock owned directly or indirectly by
   (a) a corporation in which he is a shareholder,[17]
   (b) a partnership in which he is a partner, or
   (c) an estate or trust of which he is a beneficiary.[18]
2. He must, under Section 544(a)(2), include stock owned directly or indirectly
   (a) by or for his family, and for this purpose "family" includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors and lineal descendants, and
   (b) by or for his partner.
3. He must, under Section 544(a)(3), include stock, which he can acquire through the exercise of an option, or an option to acquire an option, or any series of options.
4. He must, under Section 544(b), include stock which he may acquire through the exercise of conversion rights in outstanding securities, whether or not convertible during the taxable year. For this purpose, where securities may be convertible at various dates, the class having the earlier conversion date may be included, although the class having later dates is not, but all convertible securities having prior conversion dates must be included.

The statute has special and rather complicated rules for applying (1), (2), and (3) above.[19] Stock indirectly owned by a person under (1) or (3) is, for the purpose of applying (1) or (2), treated as actually owned by such person. But stock constructively owned by reason of (2) is not treated as owned for the purpose of again applying such rule in order to make another the constructive owner.

The application of these rules is well illustrated in the Treasury Regulations.[20] By using the combination which will result in the fewest stockholders, it can be determined whether more than 50 per cent in value of the stock was owned, directly or indirectly, at any time during the last half of the corporation's taxable year, by not more than five individuals.

In view of these statutory provisions, it is difficult to avoid the stock ownership requirement in closely held corporations. A corporation having ten equal stockholders, who were not closely related or partners, would escape the stock ownership requirement, since the holdings of no five would total over 50 per cent, but apparently ten is the minimum number of stockholders a corporation may have and avoid satisfying the stock ownership requirement. If one stockholder owns 20 per cent, there must be no other four stockholders who together own over 30 per cent. If two stockholders own 40 per cent, there must be no other three owning together over 10 per cent. It is thus obvious that in the typical family corporation it is difficult to avoid the stock ownership requirement.

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[16] 1954 IRC § 542(a)(2).

[17] The ownership may be traced through any chain of corporations. *Renton Investment Company* v. *Commissioner* (3 Cir. 1942), 131 F. 2d 330, 30 AFTR 280; *The Porto Rico Coal Co.*, 44 B.T.A. 221 (1941), affirmed (2 Cir. 1942) 126 F. 2d 212, 28 AFTR 1316.

[18] Where stock is held in trust, ownership is attributed to the beneficiary who is entitled to the dividends, that is, the life tenant rather than the remainderman. *Steuben Securities Corp.*, 1 T.C. 395 (1943).

[19] 1954 IRC § 544(a)(5).

[20] Reg. 118 § 39.503(a)-3

Where the corporation has only common stock outstanding, the determination may not be difficult and the result once ascertained will continue unless and until there are changes in stock ownership or in the relationships among the stockholders. Where the corporation has more than one class of stock outstanding and the holdings in the various classes of stock are not proportionate, the determination may be more difficult. It is then necessary to determine the value of each class of stock during the last half of each taxable year and to make the computations on that basis.[21] Obviously, it may be difficult to make an exact determination in these circumstances. Furthermore, since the relative values of preferred and common stock may change from time to time, it will be necessary to check this situation every year, even though there are no changes in stockholdings. Wherever there are changes in direct or constructive stockholdings due to sales, gifts, inheritances, changes in income beneficiaries of a trust, terminations of trusts, marriages, changes in membership of a partnership, changes in stockholders of corporate stockholders, purchase or retirement of shares by the corporation, granting or transfers of options, or issuance or transfers of convertible securities or otherwise, the computation should be rechecked.

It is most important to know whether the stock ownership requirement is satisfied and, when the result is not perfectly clear, to make careful, detailed computations. It is also important to keep these computations up to date. If it is clear that the stock ownership requirement is not satisfied during any part of the last half of a particular taxable year, the management can safely decide that the corporation is not a personal holding company for such year and make its tax returns and conduct its affairs on that basis, irrespective of the nature of the corporation's income. This is true even though the corporation was a personal holding company for the immediately preceding year. But if it is clear that the stock ownership requirement is satisfied, or if the result is doubtful, it is then necessary to consider the gross income requirement.

b. Gross income requirement. The gross requirement is that for the taxable year at least 80 per cent of the corporation's *gross income* must be "personal holding company income" as defined in the statute.[22] Under prior law, if a corporation was once classed as a personal holding company for 1937 or any later year, the 80 per cent figure was reduced to 70 per cent until:

1. a taxable year during the entire last half of which the stock ownership requirement did not exist or
2. until the expiration of three consecutive years in each of which less than 70 per cent of the corporation's gross income was personal holding company in-

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[21] Reg. 118 § 39.501-3

[22] 1954 IRC § 542(a)(1).

come.[23] But for 1954 and subsequent years the gross income percentage is 80 per cent at all times.[24]

The statute sets up eight categories of personal holding company income, familiarity with which is important.[25] The following constitute personal holding company income:

1. Dividends, interest (other than interest on purchase price of real estate held primarily for sale to customers in the ordinary course of the corporation's trade or business and interest on reserve funds deposited under the Merchant Marine Act), royalties (other than mineral, oil, or gas royalties) and annuities;[26]
2. Gains from the sale or exchange of stock or securities, except in the case of regular dealers;
3. Gains from future transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, other than those arising out of bona fide hedging transactions. Beginning with 1954, however, losses on stocks or securities may be deducted from gains on stocks or securities and losses on commodity transactions may be deducted from gains on commodity transactions, so that only the net gain in each category is included in gross income for this purpose;[27]
4. Income from estates and trusts includable in the corporation's income, and gains from the sale of any interest in an estate or trust;
5. Certain personal service compensation, or gains from the sale of a personal service contract, where the corporation under the contract collects for the services of an individual who owns, directly or indirectly, 25 per cent or more in value of its outstanding stock at any time during the year, if some person other than the corporation has the right to designate the individual or such individual is designated by name or otherwise in the contract;
6. Rents received for the use of the corporation's property from a person owning, directly or indirectly, 25 per cent or more of its capital stock at any time during the year, but only in the case of a corporation which has personal holding company income from other sources (not including rents) in excess of 10 per cent of its gross income;
7. Other rents, including certain interest on unpaid selling price of real estate, unless constituting 50 per cent or more of gross income;
8. Mineral, oil, or gas royalties, unless (A) they constitute 50 per cent or more of gross income and (B) the ordinary and necessary business expenses, other than compensation to shareholders, constitute 15 per cent or more of gross income.

Where the stock ownership requirement is satisfied, the objective must be to make certain that more than 20 per cent of the corporation's gross income is from sources other than those classified by Section 543 as personal holding company income.

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[23] 1939 IRC § 501(a)-1.
[24] 1954 IRC § 542(a)(1).
[25] 1954 IRC § 543.
[26] Only the portion of the annuity which constitutes income under 1954 IRC § 72 is included.
[27] 1954 IRC § 543(b).

3. How a Corporation Can Avoid Becoming a Personal Holding Company

Where a corporation is not a personal holding company, but it satisfies either the stock ownership requirement or the gross income requirement, it is particularly important to watch with care the status of the corporation with respect to the requirement not yet satisfied.

Thus, where 80 per cent or more of the gross income is personal holding company income, but the stock ownership requirement is not satisfied, special attention must be given to possible changes in stock ownership in closely held companies or those with a few large stockholders. Similarly, where the stock ownership requirement is satisfied, and the corporation has some personal holding company income, special attention must be given to relative changes in sources of gross income.

If the gross income requirement is satisfied and the stock held actually or constructively by not more than five individuals, computed as required by the statute, is but slightly less than 50 per cent, the acquisition of even a small amount of additional stock by any one of the five largest holders may cause the corporation to meet the stock ownership requirement. It makes no difference whether such stock is acquired, directly or constructively, by purchase, foreclosure of a pledge, gift or inheritance or in any other way. For this purpose there must be taken into account not only acquisitions by the five largest stockholders but also acquisitions by their wives, parents, children, brothers and sisters or by their partnership or partners, or by any corporation in which they are shareholders, or any trust of which they are income beneficiaries. Furthermore, the acquisition of an option to buy stock, or of securities convertible into stock, by any of these persons would have the same effect as an acquisition of stock.

Where the stock ownership situation holds potential dangers, the principal stockholders should be advised so that they, or others closely connected with them, will not unwittingly acquire stock, or stock options, or convertible securities, or enter into relationships which would affect the classification of the corporation. Many of the transactions which may be important would not automatically come to the attention of the active officers. If the first six months of the corporation's year has not yet elapsed, it may be possible to avoid the damaging effect of some inadvertent action taken with respect to stock ownership.

Such considerations may not only affect proposed purchases or gifts of stock, but also the provisions of contemplated wills or trusts, or the advisability of issuing convertible securities, if money is borrowed from the principal stockholders. Such problems arise not only with respect to the five largest stockholders but also with respect to smaller stockholders or even nonstockholders who might, by acquiring a substantial block of stock, or stock options, or convertible securities, become one of the five stockholders to be counted.

The main point is that where the gross income requirement is satisfied and there is danger that the stock ownership requirement may also be satisfied, the effect of changes in stock ownership on personal holding company classification should be given special and continued attention.

The more common situation will be that in which the stock ownership requirement is satisfied and there is danger, or the possibility, that in a particular year 80 per cent or more of the gross income will be personal holding company income. Here the result may to some extent be controlled by avoiding or consummating certain transactions or types of transactions, or by changing methods of doing business, if the parties are currently aware of the situation. It is first necessary to determine or estimate the gross income for the year and the sources of the gross income. This is not always easy to do, particularly as such forecast, to be valuable, should be made early in the year. Many problems not peculiar to personal holding corporations may be involved. For example, a parent corporation, the assets of which consist of the stock of operating subsidiaries, normally will satisfy the gross income requirement, if it is separately considered, because its entire gross income will be from dividends. Such a corporation may claim that the subsidiaries are but dummies or agents and that in fact the operating income is its income. Unless the situation is protected by a consolidated return, that question concerning the nature of the parent corporation's income must be resolved before the corporation's personal holding company status can be determined.[28] A parent corporation may perform services for its operating subsidiaries for which it makes a service charge sufficient, at least, to cover a fair share of its expenses. It may be important to determine whether such service charges are gross income,[29] or merely reimbursement of the amounts advanced for expenses, which would not constitute gross income.[30] The amount and even the character of the corporation's gross income may be affected by a reallocation of gross income made by the Commissioner under Section 482.[31] There may be problems as to whether a particular type of income should be classified as personal holding company income. It is often difficult to determine whether a particular item constitutes interest, royalties, or rent, which might be personal holding company income, or some type of nonpersonal holding company income.[32]

It must be borne in mind that it is gross income, not gross receipts or net income, which is important. Gross income from the sale of goods is not the selling price, but the excess of selling price over cost of goods sold.[33] In this principle there lurks a serious danger for a closely held manufacturing or merchandising corporation, which has some personal holding company income such as dividends, interest on bonds or accounts receivable, rent, or royalties. In a poor year the gross profits from active operations may shrink or disappear, even though there are substantial sales. The personal holding company gross income, which is ordinarily of minor importance, may be more than 80 per cent of the total gross income for that particular year. In this event the corporation, although primarily an operating company, will become a personal holding company for that year.

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[28] Compare *American Package Corp.* v. *Commissioner* (4 Cir. 1942), 125 F. 2d 413, 28 AFTR 1048, in which the taxpayer lost, with *Inland Development Co.* v. *Commissioner* (10 Cir. 1941), 120 F. 2d 986, 27 AFTR 550, in which the taxpayer won. But the latter decision was said to be in conflict with *Moline Properties, Inc.* v. *Commissioner,* 319 U.S. 436, 30 AFTR 1291 (1943). *See,* however, *National Carbide Corp.* v. *Commissioner,* 336 U.S. 422, 37 AFTR 834 (1949).

[29] *Andrew Jergens Co.* 40 B.T.A. 868 (1939); *W. A. Bechtel Co.* 42 B.T.A. 927 (1940).

[30] *Commissioner* v. *Kresge Department Stores, Inc.* (3 Cir. 1943), 134 F. 2d 76, 30 AFTR 1029, cert. den. 319 U.S. 761; *General Management Corp.* 46 B.T.A. 738 (1942), aff'd on another issue, 135 F. 2d 882 (7 Cir. 1943), cert. den. 320 U.S. 757.

[31] *Hugh Smith, Inc.* 8 T.C. 660 (1947), affirmed (6 Cir. 1949) 173 F. 2d 224, 37 AFTR 1023, cert. den. 337 U.S. 918.

[32] *Elverson Corp.* v. *Helvering* (2 Cir. 1941), 122 F. 2d 295, 27 AFTR 841; *Bond Auto Loan Corp.* v. *Commissioner* (8 Cir. 1946), 153 F. 2d 50, 34 AFTR 823; *Commissioner* v. *Clarion Oil Co.* (D.C. Cir. 1945), 148 F. 2d 671, 33 AFTR 1141, cert. den. 325 U.S. 881; *Wm. J. Lemp Brewing Company,* 18 T.C. 586 (1952); *Hopag, S.A.,* 14 T.C. 38 (1950).

[33] *Woodside Acres, Inc.* v. *Commissioner* (2 Cir. 1943), 134 F. 2d 793, 30 AFTR 1191; *Garrett Holding Corp.* 9 T.C. 1029 (1947); *McCulley* v. *Kelm* (D.C. Minn. 1953) 112 F. Supp. 832; Frank H. Levine, "Gross Income in the Personal Holding Company," *Tax Law Review,* 1954, Vol. 9, page 453.

This situation is so much of a pitfall that many have proposed that the law should be changed so as to make the test depend on gross receipts rather than gross income, so that a company which is predominantly an operating company will not be exposed to this hazard. But no such change has yet been enacted.

"Gross income" is at best an unsatisfactory measure of tax liability because of uncertainties as to exactly how gross income should be computed, particularly in manufacturing, mining, oil, agricultural, and even real estate enterprises. In determining net income, the exact classification of expenditures between cost of goods and expense is not of vital importance. But in determining gross income such classification is important. Section 29.22(a)-5 of Regulation 111 originally defined gross income of a manufacturing, merchandising, or mining business as total sales less cost of goods sold plus other income, and specifically provided:

> In determining the gross income, subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold.

Under this regulation gross income was not reduced by depreciation of plant and machinery, or by depletion. Correct determination of "cost of goods" or "gross income" under this regulation was quite difficult.[34]

This sentence was amended by T.D. 6028 and now reads in Section 39.22(a)-5 of Regulation 118 as follows:

> In determining the gross income, subtractions should not be made for depletion allowances based on discovery value or percentage of income, selling expenses, or losses, or for other items not ordinarily used in computing cost of goods sold.

If this amendment meant that cost depletion and plant depreciation had to be deducted as part of cost of goods sold in determining gross income, the change would have had an adverse effect in determining the personal holding company gross income of corporations engaged in manufacturing, merchandising, or mining. However, the Internal Revenue Service has ruled that the Regulation is permissive. Taxpayers *may* include depreciation and cost depletion (but not depletion based on discovery value or percentage of income) in cost of goods, in accordance with accepted accounting practices, but they are *not required* to do so. If such items have been consistently included in cost of goods by a taxpayer in the past, a change in this practice may be regarded as a change in accounting methods requiring approval of the Commissioner.[35]

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[34] *Montreal Mining Co.*, 2 T.C. 688 (1943), modified on stipulation (6 Cir. Oct. 17, 1944); *Frank G. Wikstrom & Sons, Inc.*, 20 T.C. 359 (1953).

[35] Rev. Rul. 141, 1953 IRB No. 16 (p. 5).

Since the test is gross income, expenses and losses play no part in the gross income requirement. Under prior law gains from the sale of securities and commodities, which are usually personal holding company income, had to be taken into account without offsetting losses from the sale of securities or commodities. For 1954 and subsequent years only the net gain from security transactions and the net gain from commodity transactions, need be taken into gross income for this purpose.[36] If gains have been realized from these sources, it may be possible to avoid personal holding company classification by taking offsetting losses. But with this single exception, losses and deductions have no bearing on the gross income requirement.

Assuming that the amount and classification of the corporation's potential gross income can be predicted with reasonable accuracy, and that there is danger that the personal holding company gross income will exceed 80 per cent of the total, what can the management do? Here is where a study of each of the categories of personal holding company income, in the light of the corporation's particular circumstances, may be fruitful.

The objective should be to minimize the personal holding company gross income and to maximize the nonpersonal holding company gross income, so that less than 80 per cent of the total gross income will be personal holding company income. Possibly, where control exists, the receipt of dividends can be deferred to a later year when conditions may be different, subject, of course, to the Section 531 problem of the dividend paying corporation. It may be that dividend paying stocks can be disposed of and the proceeds invested in non-dividend paying stocks or otherwise employed, if any gain on the sale, which will be personal holding company gross income, does not more than offset the reduction in dividends, or the gain is offset by security losses.

Potential taxable interest from corporate bonds may be converted into nontaxable interest income by a sale of the corporate bonds and reinvestment of the proceeds in tax exempt municipal bonds, the interest from which is not includable in gross income under the revenue laws.[37] Here again the effect of any profit on the sale must be taken into account.

Gains from the sale of securities can be avoided by deferring sales to a subsequent year. Possibly sales of securities can be made on the installment basis so that only a portion of the gain will have to be included in gross income for each year.[38]

A change in the method of doing business may convert what would otherwise be personal holding company income into nonpersonal holding company income. Affiliated Enterprises, Inc., the corporation which conceived the idea of "Bank Night" for motion picture theaters, initially received its income under written license agreements made with theater owners covering certain trade-marks and copyrights and the system which it was seeking to patent. This income was held to be personal holding company income in the nature of a royalty, although the company was unsuccessful in securing any patent.[39] Later, because of court decisions refusing to protect this unpatentable idea as too much like a lottery, the corporation changed its method of doing business. It received more than 20 per cent of its income under oral service contracts, in which it claimed no ownership of property but merely agreed to render 22 types of specialized advice and counsel which included the "Bank Night" plan as a business stimulator. The income from these service contracts was held not to be personal holding company income.[40]

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[36] 1954 IRC § 543(b).

[37] Reg. 118 § 39.505-1. Ordinarily it is better for the stockholders to own municipal bonds directly, rather than through a personal holding company, since such interest, although tax free to the corporation, cannot be withdrawn from the corporation except as dividends or distributions in liquidation.

[38] *Frederick Smith Enterprise Co.* v. *Commissioner* (6 Cir. 1948), 167 F. 2d 356, 36 AFTR 944.

Royalty income for the use of patents is, of course, personal holding company income, but gain from the sale of patents is not personal holding company income. A corporation receiving royalties from patents may therefore change the status of this item by making a sale of the patents. This is true even though the sale price is payable in installments measured by production, much like a royalty. This principle has been applied where the patents were sold under a contract providing for the payment of a "royalty" of 10 per cent on patented articles sold until the aggregate amount so paid equaled the selling price. Notwithstanding the form of the contract and the designation of the payments as "royalties," it was held that the transaction was in fact a sale.[41] Note, however, that the Commissioner has announced that he will not follow these decisions, and that, except for years beginning before June 1, 1950, he will treat receipts of this type as royalty income.[42] In special situations the courts are also narrowing the application of this rule.[43] The precise question here is whether such receipts will be treated as royalty income, which is personal holding company income, or gain on the sale of a patent, which is not personal holding company income. For this classification purpose it is not important whether the gain is ordinary income or capital gain.[44]

Sales of other types of property yielding personal holding company income may result in gains, which would not be personal holding company income. The statute specifically includes in personal holding company income, net gains from the sale of stock or securities, net gains from future transactions in commodities, gains from the sale of an interest in an estate or trust, and gains from the sale of personal service contracts falling within Section 543(a)(5). But gains from the sale of any other type of property are not personal holding company income. Gains from the sale of real estate or tangible personal property might stop the receipt of rents which would be personal holding company income and might create a gain which would be nonpersonal holding company income. It is entirely possible that gains from the sale of a royalty contract, an annuity contract,[45] a lease or an installment contract[46] would not constitute personal holding company income. Thus a sale of an undivided interest in the mineral content of land was treated as a conveyance of real estate and not a sale of securities.[47] It should be noted, however, that the Regulations treat as securities such things as certificates of interest or participation in any oil, gas, or other mineral royalty or lease, and gains on the sale of these would be personal holding company income.[48]

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[39] *Commissioner* v. *Affiliated Enterprises, Inc.* (10 Cir. 1941), 123 F. 2d 665, 28 AFTR 387, cert. den. 315 U.S. 812.

[40] *Affiliated Enterprises, Inc.* v. *Commissioner* (10 Cir. 1944), 140 F. 2d 647, 32 AFTR 153.

[41] *Elrod Slug Casting Machine Co.*, par. 48,041 Prentice-Hall Memorandum T.C. (1948); *Waterman* v. *Mackenzie*, 138 U.S. 252 (1891); *Commissioner* v. *Hopkinson* (2 Cir. 1942), 126 F. 2d 406, 28 AFTR 1349; *Edward C. Myers*, 6 T.C. 258 (1946); *William O'Neill Kronner* v. *U.S.* (Ct. Cl. 1953), 110 F. Supp. 730.

[42] Mim. 6490, 1950-1 C.B. 9.

[43] *Eterpen Financiera Sociedad, etc.* v. *U.S.* (Ct. Cl. 1952), 108 F. Supp. 100, cert. den. 346 U.S. 813; *Bloch* v. *U.S.* (2 Cir. 1952), 200 F. 2d 63, cert. den. 345 U.S. 935.

[44] 1954 IRC § 1235 permits an individual investor, and some individual purchasers, to treat what are substantially royalties on a capital gains basis, but this provision is not applicable to corporations.

A distinction must be made between a sale of property and the extinguishment of a contract for future payment of income. Ordinary income would be realized from commutation of future rent,[49] royalties, or other ordinary income,[50] which might be personal holding company income.

The existence of personal service income under the type of contract specified in Section 543(a)(5) certainly can be avoided. The corporation, if it has substantial other personal holding company income, can also avoid renting property to substantial stockholders and thus creating personal holding company income under Section 543(a)(6). It should be borne in mind that rental of property to a partnership composed of stockholders falls within Section 543(a)(6).[51] Furthermore, if a subsidiary corporation rents property to its parent, and the parent subleases the property to a partnership composed of stockholders, the rent received by both corporations is personal holding company income.[52] If any member of the lessee partnership, no matter how small his partnership interest, owns the required percentage of stock; the rent from the partnership would be subject to Section 543 (c)(6), since each partner is treated as the constructive owner of stock owned by his partners. If the lessees were merely joint tenants or tenants in common probably only the rent attributable to the stockholder tenant would be subject to Section 543(c)(6), unless by reason of some other relationship all of the stock would be treated as owned by the stockholder tenant.[53] Rent received from a subsidiary corporation does not fall within this category.[54] Nor would rent received from another corporation be personal holding company income under Section 543(a)(6), even though both corporations had the same stockholders. Hence one effect of the incorporation of a partnership composed of stockholders which rented real estate from the corporation would be to take the rent out of Section 543(a)(6).

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[45] *McAllister* v. *Commissioner* (2 Cir. 1946), 157 F. 2d 235, 35 AFTR 91, cert. den. 330 U.S. 826; *Bell's Estate* v. *Commissioner* (8 Cir. 1943), 137 F. 2d 454, 31 AFTR 411.

[46] *Western Acceptance Corporation,* 46 B.T.A. 828 (1942).

[47] *Plow Realty Co. of Texas,* 4 T.C. 600 (1945).

[48] Reg. 118 § 39.502-1.

[49] *Hort* v. *Commissioner,* 313 U.S. 28, 25 AFTR 1207 (1941).

[50] *Charles E. McCartney,* 12 T.C. 320 (1949); *Commissioner* v. *Starr Brothers, Inc.* (2 Cir. 1953), 204 F. 2d 673.

[51] *Furniture Finance Corp.,* 46 B.T.A. 240 (1942); *Randolph Products Co.* v. *Manning* (3 Cir. 1949), 176 F. 2d 190, 38 AFTR 281; *Walnut Street Co.* v. *Glenn* (D.C. Ky. 1948), 83 F. Supp. 945, 37 AFTR 1351.

[52] *O'Falk's Department Stores, Inc.,* 20 T.C. 56 (1953).

[53] " 'Rent' as a Factor in Imposing Personal Holding Company Penalties," 1954, *The Journal of Taxation* Vol. 1, page 10.

[54] *Minnesota Mortuaries, Inc.,* 4 T.C. 280 (1944); *O'Falk's Department Stores, Inc.,* 20 T.C. 56 (1953); *Western Transmission Co.,* 18 T.C. 818 (1952).

If the amount of rents approaches 50 per cent of gross income and the balance of the income is from dividends, interest, royalties, and similar sources, it may be possible, by some shift from security investments to investments in rental property, to bring the gross rents up to 50 per cent of gross income, in which event the rents will not count as personal holding company income. A relatively small investment in mortgaged real estate may greatly increase gross income from rents. The same procedure can be followed where mineral, oil, and gas royalties are slightly less than 50 per cent of gross income, if the other requirements of Section 543(a)(8) can be satisfied.

A careful study of Section 543 in the light of the company's particular circumstances may make it possible to minimize the personal holding company income to an extent which will keep the corporation's personal holding company gross income below the 80 per cent figure.

It may be more difficult to increase nonpersonal holding company income. Income from operations is not easily controllable on a short-term basis. Reference has already been made to the possibility of realizing gains which would build up the nonpersonal holding company income. Any type of gross income, other than those specified in Section 543, which can be brought within the taxable year, will serve for this purpose. The income may be a charge for services not falling within Section 543(a)(5), profits from the sale of merchandise, real estate or tangible personal property, whether in the ordinary course of business or not, gross income from a new line of activity, or any other nonpersonal holding company type of gross income which can be produced.

The operating or merchandising company which gets into difficulties in a bad year because of substantial shrinkage in gross income from ordinary operations may be able, by selling the relatively small amount of securities on which it is receiving dividends and interest, and using the proceeds as working capital, to minimize the amount of its personal holding company income for that particular year, provided net gains are not realized on such sales. In bad times, it may well be worthwhile to sell such securities at a loss, if that will avoid the personal holding company classification.

It is highly advisable, therefore, for a corporation which satisfies the stock ownership requirement and which is in danger of satisfying the gross income requirement, to keep the personal holding company problem definitely and continuously in mind in conducting its operations.

4. How to Operate a Personal Holding Company

Where a corporation is a personal holding company, and the management is aware that it is a personal holding company, but for some reason it must continue in that status, the corporation should be operated in such a way as to minimize the total tax liability of the corporation and its stockholders.

Since, except for the first $2,000, the personal holding company surtax rate is 85 per cent, and the individual tax brackets for 1954 do not exceed this figure until the net income on a separate return reaches $90,000, it almost always means less total tax for a personal holding company and its stockholders to have the corporation pay sufficient dividends to avoid the personal holding company tax.

The objective of the managers of a personal holding company should therefore be, first, to minimize the ordinary corporate income, and, second, to pay exactly enough dividends to avoid the personal holding company tax.

a. Ordinary income. The receipt of ordinary income by a personal holding company involves very substantial tax burdens. Hence, so far as tax considerations are concerned, such a corporation should not take in as ordinary income any items that it can avoid. Where miscellaneous investments are held, the receipt of dividends and interest usually cannot be controlled. But where the personal holding company owns or controls operating corporations, it can, within reasonable limits, control the amount of dividends, interest, rents, and royalties, that it receives from such corporations.

Arrangements for the payment of unreasonably low interest, rents, or royalties by a controlled operating company to the personal holding company may be questioned by the Commissioner under Section 482, but there is serious doubt whether the Commissioner has power, under that section, to create income by requiring an increase in such items, as that section merely gives him power to reallocate items of actual gross income or deductions.[55]

For years prior to 1954 the personal holding company status of each corporation had to be separately determined, even though the corporation was a member of an affiliated group that filed a consolidated return for income tax purposes. It was only in the case of railroad corporations that a consolidated return could be used for personal holding company purposes.[56] Hence, a parent corporation which received primarily intercompany dividends and interest, or a patent-holding subsidiary, which received primarily intercompany royalties, might be a personal holding company, although the affiliated group carried on an active integrated business. Under such circumstances, it was often worthwhile to maximize the accumulation of income in the operating subsidiary even though this involved some risk under 1939 I.R.C. Section 102.

The Internal Revenue Code of 1954 permits affiliated corporations filing a consolidated income tax return to compute the personal holding company gross income requirement on the basis of consolidated gross income and consolidated personal holding company income of the affiliated group.[57] However, this privilege is not granted if any member of the group derived 10 per cent or more of its gross income from sources outside the group and 80 per cent or more of this outside income consisted of personal holding company income. For this purpose the parent corporation is not required to treat as outside income any dividends received by it from another corporation in which it owns more than 50 per cent of the outstanding voting stock, if such other corporation was not itself a personal holding company. Under the Internal Revenue Code of 1954, therefore, a parent corporation, which separately considered is a personal holding company, may, if it owns the required 80 per cent of the stock of one or more operating companies and is willing to pay the additional 2 per cent income tax imposed on consolidated returns,[58] solve its personal holding company problem by filing a consolidated return, if the affiliated group as a whole does not meet the gross income test.

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[55] *Tennessee-Arkansas Gravel Co.* v. *Commissioner* (6 Cir. 1940), 112 F. 2d 508, 25 AFTR 97; *Laster*, 43 B.T.A. 159 (1940); this point not involved on appeal (5 Cir. 1942) 128 F. 2d 4, 29 AFTR 465; *Smith-Bridgman & Co.*, 16 T.C. 287 (1951).

[56] 1939 IRC § 501; Farrar, "The Personal Holding Company in Consolidated Returns," *Tax Law Review*, 1953, Vol. 9, page 53.

[57] 1954 IRC § 542(b).

Where the personal holding company owns less than 80 per cent of the stock, even though it may own a controlling interest, or for some reason a consolidated return is not desired, a decision as to dividend policy must be made: Should the controlled operating company pay liberal dividends so as to avoid all risk of the penalty tax on accumulated earnings, even though the parent company will have to redistribute such dividends to its stockholders who may be subject to high rates of personal income tax? Or, should the operating company adopt a conservative dividend policy and accumulate a substantial part of its earnings, even though that involves some risk of incurring the tax under Section 531?

In making this decision, it should be borne in mind that the tax under Section 531 is at 28½ per cent on the first $100,000 and at 38½ per cent on the balance; that such tax is now measured only by the portion of the undistributed earnings in excess of the amounts retained for the reasonable needs and reasonably anticipated needs of the business; and that, if there are minority stockholders, difficulties may be encountered if the operating company is penalized under Section 531 for failure to distribute sufficient dividends.

b. Long-term capital gains. The principal, if not the sole, advantage of personal holding company status is in the tax treatment of net long-term capital gains. The excess of net long-term capital gains over net short-term capital losses (less the income tax attributable thereto) is deductible in determining undistributed personal holding company income.[59] Furthermore, a personal holding company is not subject to tax on accumulated earnings under Section 531. To the extent, therefore, that a personal holding company has net long-term capital gain on which its ordinary income tax is limited to 26 per cent for taxable years beginning prior to April 1, 1954 (and to 25 per cent thereafter), it is subject to no further tax even though it does not distribute such long-term capital gains. Under prior law, the 26 per cent tax on net long-term capital gains which must be paid to the Government, was deductible in determining the undistributed Subchapter A net income, so that this tax could, in effect, be paid out of income which would otherwise have to be distributed, and the full long-term gain on the sale of the capital assets could be retained in the corporation. Under the Internal Revenue Code of 1954 this advantage is reduced, by virtue of the provision of Section 545(b)(5) requiring the deduction for net long-time capital gain to be reduced by the income tax attributable thereto.

In a very real sense the capital gain feature of personal holding companies is not advantageous from the tax standpoint. If the stockholders directly owned the capital asset sold at a gain, the individual income taxes would be 25 per cent of the long-term gain and there would be no further tax liability. If a personal holding company holds and sells the assets at the same gain, there is the corporate income tax of 26 per cent (or 25 per cent for taxable years beginning on April 1, 1954 or later) to pay and the balance of the gain may be accumulated. Since the stockholders have gained no income tax advantage by having the corporation rather than the individuals realize the profits, the law does not require such long-term capital gains of personal holding companies to be distributed as an ordinary dividend. It is a disadvantage, however, to have the retained 74 or 75 per cent of the gain in the corporation rather than in the hands of the stockholders, because this amount cannot be withdrawn by the stockholders from the corporation except by way of dividends or distributions in liquidation, involving further tax burdens.

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[58] 1954 IRC §§ 1503, 1504.

[59] 1954 IRC § 545(b)(5).

If a personal holding company holds capital assets that have appreciated in value, the treatment of capital gains is an important consideration. If the gain is realized as a short-term capital gain, it is ordinary income subject to perhaps 52 per cent corporation income tax, and the balance of the gain must be distributed as dividends. If the gain is a long-term capital gain, the corporation income tax is but 26 (or 25) per cent and the balance of the gain can be accumulated without penalty. It is therefore particularly important to a personal holding company to have long-term capital gains rather than short-term capital gains. From a tax standpoint, a personal holding company should prefer investments which it holds primarily for long-term increase in value rather than for current return in the form of interest and dividends.

A personal holding company gets the benefit of a net capital loss carry-over from prior years for personal holding company tax purposes,[60] but it can deduct capital losses for personal holding company tax purposes only to the same extent as for ordinary income tax purposes.

While the treatment of long-term capital gains is somewhat favorable in the case of personal holding companies, it is doubtful whether any corporation should seek the burdensome personal holding company status for the purpose of getting this advantage.

c. Income in controversy. It is particularly unfortunate for a personal holding company to receive income under claim of right where its right to keep such income is in controversy. From a business standpoint the fund should be held intact, so that the money will be available if the outcome of the controversy is unfavorable. But this income is first subjected to the ordinary corporate income tax.[61] Then, if the balance of the income is not distributed, the heavy personal holding company surtax will be incurred.[62] If distributions are made to avoid the personal holding company tax, the distributions will subject the stockholders to substantial income taxes. If and when the company is required to pay the amount in controversy to someone else, the funds are no longer available either in the hands of the corporation or its stockholders. Every effort should be made to avoid this situation through an escrow agreement or otherwise.

d. Expense deductions. Salaries to shareholders rendering services to the corporation should be kept as high as possible without incurring too much risk that the deduction of such salaries will be disallowed as unreasonable. By deducting such salaries the corporation saves the 52 per cent income tax and the income tax to the shareholders on salaries only slightly exceeds the individual income tax on dividends. However, it should be borne in mind that if salaries and other deductions exceed the corporation's income from sources other than dividends, so that the net income is less than the gross dividends, this results in a limitation of the dividend-received deduction to 85 per cent of the taxable income.[63] To this extent such deductions, instead of saving 52 per cent corporate income tax, save only 7.8 per cent corporation income tax. Furthermore, if salaries are held to be unreasonable and are disallowed in part as deductions, the excess even though paid to stockholders and regarded as in the nature of a dividend, will not be allowed for personal holding company purposes as a dividend paid, unless by chance the excessive compensation was paid pro rata to all stockholders.[64]

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[60] 1954 IRC § 1212.

[61] *North American Oil Consolidated* v. *Burnet* (1932) 286 U.S. 417; *E. E. Healy* v. *Commissioner* (1953) 345 U.S. 278.

[62] *Safety Tube Corporation* v. *Commissioner* (6 Cir. 1948), 168 F. 2d 787, 36 AFTR 1120; *see Knight Newspapers* v. *Commissioner* (6 Cir. 1944), 143 F. 2d 1007, 32 AFTR 1111.

e. Charitable contributions. For ordinary corporation income tax purposes, the deduction for contributions to charity is limited to 5 per cent of taxable income.[65] In determining undistributed personal holding company income, charitable contributions may be deducted up to 20 per cent, or even 30 per cent, of adjusted gross income, the limitation applicable to individuals.[66] Such contributions between the 5 per cent and 20 per cent or 30 per cent limitations thus reduce the 85 per cent personal holding company surtax but do not affect the 52 per cent income tax.

In this connection, it might be kept in mind that, under present law, if gifts of securities that have appreciated in value are made to charity, the deduction is measured by the fair market value of the securities so given, but the appreciation in value is not income to the corporation. The personal holding company gains a substantial tax advantage by giving to charity securities the cost of which is within the 5 per cent limitation and the market value of which exceeds the 5 per cent limitation, but is within the 20 or 30 per cent limitation. Although its deduction for ordinary income tax purposes is limited to 5 per cent, it avoids the tax on the appreciation in value which it would incur if it sold the securities. At the same time it gets a larger deduction for personal holding company tax purposes.

f. Dividends. To avoid the personal holding company tax, a personal holding company must distribute dividends sufficient to cover its undistributed personal holding company income. Generally the deduction allowed is for dividends paid. The greater portion of these dividends must be paid within the taxable year. There can, however, be included dividends paid after the close of the taxable year and before the 15th day of the third month following the close of the taxable year, but such post-year dividends cannot, for this purpose, exceed 10 per cent of the dividends paid during the taxable year plus any consent-dividends credit for such year.[67]

Hence an accurate estimate of the undistributed personal holding company net income of the corporation must be made before the end of the taxable year and dividends of at least 91 per cent of this amount must be paid within the year. Then within the following two and a half months, after an exact determination of income is made, further dividends to cover the balance of the undistributed personal holding company income must be paid and claimed in the return as applicable to the prior year. It is important that the dividends paid be not less than the personal holding company income, as even on the first $2,000 of accumulated income the personal holding company tax is 75 per cent. On the other hand, it is important that the dividends be not greater than such income, as that involves unnecessarily large dividend income to stockholders.

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[63] 1954 IRC § 246(b).

[64] 1954 IRC § 562(c); *W. T. Wilson*, 10 T.C. 251 (1948), affirmed on other issues sub. nom. *Wilson Bros. & Co. v. Commissioner* (9 Cir. 1948), 170 F. 2d 423, 37 AFTR 532, cert. den. 336 U.S. 909.

[65] 1954 IRC § 170(b)(2).

[66] 1954 IRC § 545(b)(2).

[67] 1954 IRC § 563.

If it should develop that the dividends paid in a particular year were somewhat more than necessary, the result is not too serious. Provision is made in Section 564 for including in the dividends paid deduction a dividend carryover from each of the two preceding years and this dividend carryover is included in the dividends paid deduction. The dividends must not be disproportionate to stockholdings or the benefit of the deduction will be lost.[68] If a dividend is paid in property which has appreciated in value, the deduction for dividends paid is not necessarily the full value of the property. If the recipient is a corporation, the distribution is a dividend only to the extent of the adjusted basis of the property to the distributing corporation, except in special situations where the distributing corporation must account for the appreciation.[69]

If the recipient is noncorporate, he must account for the full fair market value of the property. Under prior law, even in such a case, the dividends paid credit was limited to the adjusted basis of the property to the distributing corporation.[70] This limitation is not continued in Sections 561 or 562 of the 1954 Code and does not seem to be covered elsewhere in that Code.

Under this statutory pattern, it is interesting to speculate as to the effect on a personal holding company of the receipt of a dividend paid in property which has appreciated in value.

Assume that a personal holding company has a net cash income after taxes of $400,000. It also receives, as a dividend in property, securities worth $500,000 which cost the distributing corporation but $100,000. The net income of the personal holding company is increased by $100,000 of dividend income[71] and the tax basis for the securities received is $100,000.[72] The corporation needs a dividend paid deduction of $500,000 to protect it from the personal holding company tax.

The personal holding company can distribute a cash dividend of $500,000 and continue to hold the securities received in kind with a tax basis of $100,000, or the personal holding company can distribute the dividend securities received, worth $500,000, as a dividend in kind to its individual stockholders. The corporation realizes no gain from such a distribution in kind.[73] Nor will its earnings and profits be increased by the unrealized appreciation of $400,000.[74] Its earnings and profits will be reduced by $100,000,[75] the same amount as was included in income.

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[68] 1954 IRC § 562(c), *Hugh Smith, Inc.* v. *Commissioner* (6 Cir. 1949), 173 F. 2d 224, 37 AFTR 1023, cert. den. 337 U.S. 918; *St. Clair Estate Co.*, 9 T.C. 392 (1947), appeal dismissed (9 Cir. 1948); *Black Motor Co. Inc.* v. *Commissioner* (6 Cir. 1942), 125 F. 2d 977, 28 AFTR 1193; *Safety Convoy Co. Inc.* v. *Thomas* (5 Cir. 1943), 139 F. 2d 219, 31 AFTR 1036.

[69] 1954 IRC § 301(b).

[70] 1939 IRC § 27(d).

[71] 1954 IRC § 301(b)(1)(B).

[72] 1954 IRC § 301(d)(2).

[73] 1954 IRC § 311(a)(2).

The individual stockholders will receive $500,000 of dividend income, since the company has current earnings available for dividends of $500,000.[76] The corporation will get a dividend paid deduction of $500,000.[77]

The corporation will still have on hand the $400,000 of cash net income which it can retain. If, in addition to the dividend in property of $500,000, it distributes this $400,000, the stockholders will either:

(1) receive further dividend income, to the extent that the corporation accumulated earnings and profits while not a personal holding company,[78] or

(2) receive a distribution which is not a dividend and which will reduce the basis of their stock or, if in excess of such basis, constitute a capital gain to the extent of the excess.[79]

In such a situation, a study of the possibilities under the Internal Revenue Code of 1954 may lead to some interesting results.[80]

To get the benefit of the dividends paid deduction, the dividend must be actually paid, and not merely declared, within the prescribed time.[81] However, the crediting to stockholders of dividends declared may constitute payment for this purpose, where the amounts are withdrawable at any time without restriction.[82]

Credit is allowed only for distributions which have the status of taxable dividends. To protect personal holding companies it was found necessary to provide in Section 312(a)(3) for the inclusion in the definition of a "dividend" of any distributions to the shareholders of a personal holding company to the extent of its undistributed personal holding company income, even though such distributions might not fall within the ordinary definition of a dividend. The mere fact that some stockholders are not subject to tax because they are exempt corporations or nonresident aliens should not disqualify ordinary dividend distributions; however, there has been some controversy on this point.[83]

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[74] 1954 IRC § 312.

[75] 1954 IRC § 312(a)(3).

[76] 1954 IRC §§ 301(b)(1), 316.

[77] 1954 IRC § 561(a)(1).

[78] 1954 IRC § 316.

[79] 1954 IRC § 301(c)(2) and (3).

[80] It may be contended that since earnings and profits are reduced by only $100,000, the adjusted basis of the property distributed, the term 'dividends paid' as used in Sec. 561 should be construed in such a case to mean such adjusted basis rather than the fair market value of the property for which the individual stockholders must account, but such a contention would seem to be inconsistent with the definition of a dividend in Sec. 316. Perhaps some contention may be based on *Commissioner* v. *Hirshon*, 213 F. 2d 523 (2 Cir. 1954), and *Commissioner* v. *Godley*, 213 F. 2d 529 (3 Cir. 1954), which held under prior law that a distribution of appreciated property was a dividend if normal earings and profits covered its cost to the corporation, but the 1954 Code is very specific in Sec. 312 (a) as to the effect of a distribution in kind on earnings and profits.

[81] *George M. Cox, Inc.* v. *Commissioner* (5 Cir. 1942), 128 F. 2d 957, 29 AFTR 753; *Schinebro, Inc.* v. *Commissioner* (2 Cir. 1942), 131 F. 2d 504, 30 AFTR 311; *St. Clair Estate Co.*, 9 T.C. 392 (1947), appeal dismissed (9 Cer. 1948).

[82] *St. Clair Estate Co.*, 9 T.C. 392 (1947) appeal dismissed (9 Cir. 1948); See *International Bedeaux Co.* v. *Commissioner*, 204 F. 2d 870 (2 Cir. 1953).

[83] See *Tax Law Review*, Vol. 1, pp. 218, 440, 448 (1945-1946).

Where distribution of dividends is impracticable for financial reasons, the situation can be taken care of by consent dividends as provided in Section 565. Under this section the stockholders account for dividend income, even though the dividends are not actually paid.

Deduction for income taxes. The prior statute provided for the deduction in computing Subchapter A net income, of federal income taxes "paid or accrued" during the taxable year. The Internal Revenue Service, in accordance with ordinary accounting principles, took the view that the deduction had to be consistent with the method of accounting employed. In the case of a personal holding company on a cash basis of accounting and with fluctuating income, great hardship might result from the limitation of the deduction for income taxes to the taxes paid during the year. The company might have to distribute as dividends, out of income of an exceptionally profitable year, amounts which it needs to pay within a few months to the Government as taxes and which it can not pay out of current income.

Most courts recognized that a literal construction of the prior statute led to inequitable results which Congress could not have intended. Hence, they allowed a personal holding company, even though it was on a cash basis of accounting, to deduct accrued income taxes in computing its Subchapter A net income.[84] One court even held that a personal holding company on a cash basis could deduct both the taxes accrued and the taxes paid.[85] The Internal Revenue Service has finally agreed that under the prior law a personal holding company on a cash basis of accounting may deduct the taxes accrued, if it follows a consistent practice.[86]

This problem is clarified in the Internal Revenue Code of 1954, which provides a general rule that, in determining undistributed personal holding company income, federal income taxes "accrued" shall be deducted in all cases. However, a taxpayer which has in the past deducted such taxes when paid, is required to continue to deduct such taxes when paid unless it irrevocably elects, in a return for a taxable year ending after June 30, 1954, to deduct taxes when accrued.[87]

No credit for foreign income taxes is allowed against the personal holding company tax, but such taxes are allowed as a deduction in computing undistributed personal holding company income to the extent not already deducted for income tax purposes but claimed as a credit.[88]

h. Net loss on renting property. A personal holding company renting property to any tenant should have in mind the provisions of Section 545(b)(8). This section denies to the corporation as a deduction in computing personal holding company income any loss from such a transaction without proof:

(1) that the rent was the highest obtainable,

(2) that the property was held in the course of a bona fide business conducted for profit, and

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[84] *Rodney Inc.* v. *Hoey* (D.C. N.Y. 1944), 53 F. Supp. 604, 32 AFTR 302; *Commissioner* v. *Clarion Oil Co.* (D.C. Civ. 1945), 148 F. 2d 671,33 AFTR 1141; *Aramo-Stiftung* v. *Commissioner* (2 Cir. 1949), 172 F. 2d 896, 37 AFTR 958: *Reliance Feed & Grain Co., Inc.* v. *Shaughnessey* (D.C. N.Y. 1949), 84 F. Supp. 389, 37 AFTR 1584; *Wm. J. Lemp Brewing Co.*, 18 T.C. 586 (1952); cf. *New Oakmont Corporation* v. *U.S.* (Ct. Cl. 1949), 86 F. Supp. 897, 38 AFTR 920.

[85] *Birmingham* v. *Loetscher Co.* (8 Cir. 1951), 188 F. 2d 78, 40 AFTR 358.

[86] T.D. 6079, 1954-2 IRB 276.

[87] 1954 IRC § 545(b)(1).

[88] 1954 IRC § 545(b)(1).

(3) that there was a reasonable expectation of profit, or that the holding of the property was necessary for the conduct of the business.

These provisions were aimed at the practice of transferring country homes, yachts and the like to a corporation which would rent the property to its principal stockholders and prevent the corporation from deducting a net loss from such a transaction. The provisions, however, apply to all situations where property is rented to anyone even though it is a bona fide business property, the rent is fair, and the net loss would have been deductible if the stockholders had owned the property directly.[89]

i. Net operating loss. A personal holding company should make every effort to avoid sustaining a net operating loss for any year. The net operating loss deduction provided for in Section 172 for ordinary income tax purposes, under which a net operating loss may be carried back for 2 years and carried forward for 5 years, is denied for personal holding company surtax purposes, but the net operating loss for the immediately preceding year is allowed.[90]

j. Incurring indebtedness. There is no way in which a personal holding company can pay off debts out of ordinary income, except in the case of indebtedness existing on January 1, 1934, when the personal holding company classification began. Special provision for payment of such pre-1934 debts is made in Section 545(b)(7). If a personal holding company must borrow money, it should therefore do so with the realization that it can pay off the debt only out of capital funds or proceeds of the sale of property, including 74 per cent of any long-term capital gains realized thereon. It cannot accumulate ordinary income by using it to pay off indebtedness.

k. Adjustments of income or deductions on audit. It has previously been emphasized that it is important to determine accurately the gross income and deductions of a personal holding company, so that sufficient dividends can be distributed within the taxable year or, to a minor extent, within two and one-half months thereafter. It is always possible, however, that upon audit of the returns the Commissioner may make adjustments resulting in a larger net income or a larger undistributed personal holding company income, with resulting deficiencies both in income tax and in the personal holding company surtax.

The statute provides for substantial relief in this situation by a complicated provision for deficiency dividends.[91] Under this provision it is possible, within 90 days after a deficiency in personal holding company tax is finally determined, to offset the deficiency by a credit or refund to the extent of the deficiency in personal holding company tax by distributing special deficiency dividends. However, interest must nevertheless be paid on any deficiency offset by such a credit, and any refund of tax paid is without interest. Deficiency dividends are, of course, income to the stockholders when paid and do not count as a dividend distribution against the income of the later year.

l. Foreign corporations. There are problems peculiar to foreign corporations not otherwise exempted from personal holding company classification by treaty, or because they are foreign personal holding companies.[92] Such foreign corporations are subject to the personal holding company provisions whether they are resident or nonresident. They take into account for the gross income test only income from sources within the United States, but all of such income is taken into account, whether or not it is the type of income subject to withholding.[93]

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[89] *Wilson Bros. v. Commissioner* (9 Cir. 1948), 170 F. 2d 423, 37 AFTR 532, cert. den. 336 U.S. 909.

[90] 1954 IRC § 545(b)(4).

[91] 1954 IRC § 547.

Thus, a nonresident foreign operating company, if its stock is closely held, may become a personal holding company by investing a small amount in stocks or bonds of United States corporations, if it has any stockholders who are citizens of the United States. Such a corporation's ordinary income tax would be satisfied by withholding on the interest and dividends. Its nonresident alien shareholders would not be taxable on any dividends distributed to them. Yet the company would be required to file a return because of the personal holding company tax and would be subject to penalties, if it did not do so, and subject to the personal holding company tax if it had any undistributed personal holding company income.[94] Furthermore, if such a corporation filed no return, it would be entitled to no deductions or credits.[95]

What may be done to minimize the tax burden of a personal holding company and its stockholders in a particular case depends largely on a study of the special circumstances of the corporation and its stockholders in the light of the statute. Changing tax rates, individual losses of stockholders enabling them to receive dividends without tax burden, differing fiscal years when tax rates are changing, the distribution of stock to children or grandchildren or trusts to reduce individual income taxes, and a multitude of other special circumstances may afford a basis for temporary or permanent reduction of the over-all tax burden. A study of the operations of the particular company in the light of all the special provisions of Part III of Subchapter G of Subtitle A is worthwhile.

5. How a Corporation Can Cease to be a Personal Holding Company

If a corporation qualifies as a personal holding company, the methods available to terminate that classification for the future involve additional considerations. Prompt escape is possible through changes in stock ownership or termination of the corporation's existence, or through changes in the source of gross income for the taxable year.

If changes in stock ownership can be effected so that the stock ownership requirement is not satisfied at any time during the last half of the corporation's taxable year, the corporation is not a personal holding company for that year.

If the corporation is completely liquidated, it is no longer a personal holding company because it is no longer a corporation. It must, however, distribute its assets and cease operations. If it continues in process of liquidation it may still be a personal holding company. In fact, a corporation that is not a personal holding company may, in the process of liquidation become one for the first time because of the disappearance of operating income.[96] Upon such a liquidation the stockholders will, of course, realize capital gain or loss subject to individual income tax.

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[92] *See* footnote 6.

[93] Reg. 118, § 39.500-1; *The Porto Rico Coal Co.* v. *Commissioner* (2 Cir. 1942), 126 F. 2d 212, 28 AFTR 1316.

[94] A. G. *Fides* v. *Commissioner* (4 Cir. 1943), 137 F. 2d 731, 31 AFTR 570, cert. den. 320 U.S. 797.

[95] 1954 IRC § 882(c).

If a personal holding company were completely liquidated during the first half of its normal taxable year, it could perhaps be claimed that it did not satisfy the stock ownership requirement at any time during the last half of its taxable year. But it probably would be held that its taxable year was the short period prior to its complete liquidation for which a tax return must be filed,[97] and this claim would be denied.

A further question is whether or not a personal holding company, which plans to liquidate, should first distribute as an ordinary dividend an amount equal to its undistributed personal holding company income for the current year. If it makes such a dividend distribution, it will protect itself from the personal holding company tax, but its stockholders will receive dividend income. The question is whether it can safely omit the distribution of such a dividend and thus avoid dividend income to the stockholders and claim that it cannot possibly be subject to a tax imposed on undistributed income, since it has distributed all of its assets during the year.

Normally, the dividends paid deduction is allowed in the case of amounts distributed in liquidation for the part of such distribution which is properly chargeable to earnings and to profits.[98] This rule applies even though part of the distribution is a nontaxable return of cost to the stockholders.[99] In the ordinary case of the complete liquidation of a personal holding company which had accumulated earnings and profits at the beginning of the year and current earnings, it would seem that, under this principle, a portion of the liquidating distribution equal to the accumulated earnings and profits, including current earnings, would necessarily be chargeable to earnings and profits and allowed as a dividend deduction, as both earnings and profits and capital accounts would be fully offset by credits. If, however, the corporation had a deficit in its earnings and profits at the beginning of the year, its accumulated earnings and profits would be less than the current income or there might be no accumulated earnings and profits.

Even in such a case, the courts have been reluctant to impose a tax based on undistributed income on a corporation which has completely liquidated, as such a result would be a patent perversion of the purpose of the statute. In cases in which, for some technical reason, distributions made prior to complete liquidation, or in complete liquidation, did not qualify for the dividends paid credit, the courts have held that Congress could not have intended that this penalty tax on undistributed earnings should apply.[100] The Tax Court, however, refused to agree with this principle and continues to apply the technical requirements of the statute. One such decision by the Tax Court was appealed to the Court of Appeals for the Second Circuit and that court, applying the Dobson rule, affirmed this decision notwithstanding its prior decision to the contrary.[101] The result in such a case might be different today, since the Dobson rule is no longer in effect.

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[96] *O'Sullivan Rubber Co.* v. *Commissioner* (2 Cir. 1941), 120 F. 2d 845, 27 AFTR 529.

[97] Reg. 118, § 39.52-1.

[98] 1954 IRC § 562(b).

[99] *Fowler Bros. & Cox, Inc.* v. *Commissioner* (6 Cir. 1943), 138 F. 2d 774, AFTR 830.

[100] *Pembroke Realty & Securities Corporation* v. *Commissioner* (2 Cir. 1941), 122 F. 2d 252, 27 AFTR 833; *Fisher* v. *Kavanaugh* (D.C. Mich. 1951), 100 F. Supp. 248.

In view of the holding of the Tax Court in the Brooklyn National case, the corporation's situation should be carefully checked before it is decided to omit an ordinary dividend in advance of complete liquidation by a personal holding company which has current earnings. In this connection, note the new provision of 1954 IRC § 562(b) as to the effect of distributions made within 24 months after the adoption of a plan of complete liquidation.

A merger or consolidation of a personal holding company into another corporation, whether an operating subsidiary or an independent company, will terminate the existence of the personal holding company. The status of the continuing company will depend on its stock onwership and sources of gross income. Here, again, even if the transaction is completed in the first half of the taxable year of the personal holding company, the liquidating company must guard against personal holding company tax liability. Its taxable year is the short period up to the date of the merger. Its earnings and profits are not distributed by the merger, but become part of the earnings and profits of the continuing company under the Sansome rule, available for dividend distributions in the hands of the continuing company.[102] Later distributions by the transferee may, however, by appropriate action be apportioned and allocated to the transferor.[103]

The alternative method of escaping personal holding company classification by changing the character of the corporation's gross income is less promising.

What can be done in the way of reducing the percentage of personal holding company income, or increasing the nonpersonal holding company income, through changing the nature of the company's investments, or engaging in or avoiding certain types of transactions, or taking on new nonpersonal holding company operations, depends on the facts and circumstances of the particular situation.

There are, of course, relatively few personal holding companies, as their formation and continuance are deliberately discouraged by the tax law. In a sense, therefore, the problem of personal holding companies is not of broad interest. But the statutory definition is rigid and fixed. Motives and good faith do not affect the situation. The statute contains pitfalls and traps for the unwary and those who are not fully advised. A surprising number of corporations have been held to be personal holding companies, where the management and the stockholders did not know that this was the fact. The consequences of the personal holding company classification are so burdensome that the management of every closely held corporation must constantly keep in mind the possibility of being placed in such a classification.

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[103] Reg. 118, § 39.27(g)-1(c).

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6

The Collapsible Corporation Problem

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Since the advent in 1950 of Section 117(m) of the Internal Revenue Code[1] stockholders of every corporation have become aware of and must give due consideration to the "collapsible corporation" problem before they either dispose of any portion of their stock, or before they vote to dissolve the corporation. This does not mean that the problem is present in all such cases, or even in a small percentage of them. However, the tax involvement resulting from a failure to recognize the applicability of this provision is the difference between a tax on a capital gain and a tax on ordinary income. In these days of high personal surtaxes the penalty for overlooking a collapsible situation may be extremely costly.

1. Points to Consider

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2. What is a Collapsible Corporation?

The term "collapsible corporation" has found its way into tax thinking and terminology in recent years. The basic idea conveyed by the expression is a corporation which is prematurely dissolved before ordinary income is realized.[2] The most usual illustration is a corporation organized to produce a single moving picture. When the film has been completed but before the distribution contracts have begun to throw off ordinary income, the corporation is dissolved. The distribution contracts are taken as liquidating dividends in kind by the shareholders at their fair market value, and a capital gain tax paid. Thereafter this cost is amortized by the former shareholders over the useful life of the film and offset against the income received. A somewhat similar pattern is used in collapsing construction corporations. The main purpose is to receive capital gains instead of ordinary income through the use of the corporate device.

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[1] Revenue Act of 1950, § 212, as amended by § 326(a) of the Revenue Act of 1951, and as further amended and re-enacted in 1954 IRC, § 341.

[2] Section 117(m)(2)(A) also considers the sale of stock a collapsible event in similar circumstances.

The enactment of Section 117(m) by Congress in 1950[3] was designed to block the conversion of ordinary income into capital gain through the device of the collapsible corporation. Unfortunately, the section as drafted has proven vague and indefinite. The Bureau's efforts to correct the situation by regulation have not met with complete success. In many areas taxpayers are left to their own judgment and that of their advisers. The provisions were further strengthened by the Revenue Act of 1954 with the enactment of Section 341.

a. The statutory definition. Both Section 117(m)(2)(A) and Section 341(b) of the 1939 and 1954 Codes respectively define a collapsible corporation as a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the purchase of property which would be considered inventory in the hands of the taxpayer with a view to the sale or exchange of stock by its shareholders (whether in liquidation or not) prior to realization of a substantial part of the net income to be derived from such property. The most crucial wording of this extended definition is "prior to the realization of a substantial part of the net income derived from said property." The term "substantial" is nowhere defined either in the Statute or in the Regulations. Does the term mean "material" part of the income, as has been suggested?[4] Does it mean 70 per cent of the net income, in analogy to the provisions of Section 117(m)(3)(B) and Section 341(d)(2) which will be discussed below. There is no authoritative or categorical answer which can be given at this time. Only time will supply the proper interpretation in the form of Court decisions and administrative rulings.

Another word which can cause trouble in the definition of collapsibility above quoted, is the word "principally." Both its meaning and its grammatical connection with the remaining statutory language of Section 117(m)(2)(A) are far from clear. Regulation 111, Section 29.117-11 apparently equates "principally" with the expression, "a view to," and uses it to modify "formed or availed of." The test then becomes subjective rather than objective, creating an additional hazard for the unhappy taxpayer, who upon challenge by the Bureau must *disprove* any intent to form or avail of the corporation for collapsible purposes.[5]

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[3] Revenue Act of 1950, § 212, as amended. The Commissioner's efforts to meet the problem for prior years failed in the Courts. *Herbert* v. *Riddell*, 103 F. Supp. 369 (D.C. Calif., 1952). Note, also, *Frank E. Gilman* (1950), 14 T.C. 833, where the Bureau attempted unsuccessfully to attack a liquidating distribution of a corporation under prior law.

[4] Freeman, Lionel J., "Collapsible Corporations." *Proceedings of New York University Eleventh Annual Institute on Federal Taxation*, page 424. New York: Matthew Bender and Company, 1953.

[5] The burden of proof normally is on the taxpayer after the issuance by the Commissioner of the statutory notice. Rule 32, Rules of the Tax Court of the United States.

The statute operates to turn capital gain into ordinary income where a corporation has been collapsed either by liquidation or the sale of stock. The favorable treatment otherwise afforded by former Sections 117 and 115(c) is thus withdrawn. However, the law has further provisions which limit its applicability.

In enacting Section 341 of the Revenue Act of 1954, Congress has, as stated, further strengthened the provisions of the prior law. The House of Representatives had rather naively omitted any direct attack on the collapsible problem, and eliminated the provisions of Section 117(m) by allowing the sale of stock. The House had expressed its disapproval of the subjective tests laid down in Section 117(m). The purchaser of the stock acquired "inventory type assets" and would, upon the disposal of such property after a corporate liquidation, receive ordinary income. The Senate Finance Committee felt that this approach to the problem would penalize the unwary purchaser, and in effect permit the real instigator of the collapse to escape. The Senate therefore reinstated the provisions of former Section 117(m) and added two further provisions.

First, Section 341(a)(3) provides that a distribution made out of the proceeds of a loan which exceeds the adjusted basis of the property upon which the loan is secured is to be considered gain from the collapse of a corporation. The gain to the extent it exceeds the basis of the stock under Section 301(c)(3)(A) of the Revenue Act of 1954 is gain from the sale of other than a capital asset. This provision supplements Section 312(j) of the new Code with respect to loans insured by the United States. Thus the stockholders of a corporation, otherwise meeting the collapsible test, which distributes the proceeds of a loan in excess of the adjusted basis of the property on which it is secured, receive ordinary income.

Secondly, the new section has added a definition of "Section 341 assets," which are assets held for less than three years and would be includable in inventory under Section 312(b)(2). These include items normally included in inventory, and unrealized receivables or fees received from sales or exchanges of assets other than capital assets or services rendered or to be rendered. See Section 341(b)(4). Under the amendments to the law, a corporation is deemed to be collapsible unless shown to the contrary, if the fair market value of its Section 341 assets is 50 per cent or more of the fair market value of its total assets and 120 per cent or more of the adjusted basis of such assets. Even if this new test is met by a corporation it may still be collapsible under the remaining provisions of Section 341. Thus the word "property" as used in Section 341(b)(2) of the new law refers to property manufactured, constructed, produced, or purchased to any extent by a corporation or by a corporation having a basis referable to a person who manufactured, constructed, produced, or purchased such property. The three-year period, later referred to, does not commence until the completion of the manufacture, construction, production, or sale of the property. Literally construed, there may never be a date of completion in certain types of property. It can be said that a corporation engaged in publishing a book has never completed publication, since new editions are always possible. This vagueness of language makes the law more dangerous. Regulation 118 gives no help on this point, nor do the amendments contained in Section 341.

b. The stock ownership requirement. The capital gains of all stockholders of a collapsible corporation are not converted into ordinary income. Under former Section 117(m) only the gains of those shareholders owning 10 per cent or more in value of the outstanding stock of the corporation are affected. A shareholder for purposes of computing the 10 per cent ownership proviso is deemed to own the stock of his spouse, brothers, sisters, parents, and descendants, as in the case of personal holding companies,[6] but also the stock of spouses of brothers and sisters, and spouses of descendants. This percentage of ownership is reduced by Section 341 of the new law to 5 per cent.

In computing the value of outstanding stock for the purposes of Section 117(m), Treasury stock was not considered outstanding. The same is true under Section 341.

c. The 70 per cent rule with respect to gains. A corporation will not be deemed collapsible unless on its liquidation (or the sale of its stock) 70 per cent of the gain is attributable to the property manufactured, produced or purchased by the corporation. The 70 per cent rule refers, not to income realized during the life of the corporation, but to the gain on its collapse.

The statute and the regulations do not clarify what is meant by "gain attributable to the property." If the gain of the stockholders is attributable to the extent of 31 per cent to other factors than the property manufactured, produced or purchased, the statutory provisions do not apply. The very vagueness of this test makes future litigation inevitable. The gain on corporate liquidation is itself a matter of valuation, dependent on the fair market value of the assets received to the extent they exceed the shareholder's basis for stock. This provision makes it doubly important not only that a correct over-all value be arrived at, but that the separate values be attributed in the correct proportion to the various assets received in liquidation (or disposed of on the sale of the stock).

The attempt in the Regulations[7] to resolve this problem of interpretation in an indirect or negative manner by asking what the gain would be if the property had not been manufactured, produced, or purchased, is of little assistance. May purchasers of the stock or stockholders on liquidation escape collapsibility by attributing 31 per cent of their gain to other factors than the property in question? Certainly the Bureau will not accept their attempts so to do as final. However, in the case of an arm's-length transaction, the purchaser's evaluation of the underlying assets might well prove extremely helpful. This provision also should prove conducive of litigation.

d. The three-year limitation. If the corporation is not collapsed until three years or more after the actual completion of the manufacture, construction, production, or purchase of the property, Section 341 will not apply. This problem has previously been alluded to under Part 2(a), *supra.*

The Regulation[8] states that the section does not apply to that portion of the gain realized more than three years after the actual completion of the property to which such portion is attributable. This apparently means that in a corporate liquidation or upon the sale of stock there can be a hybrid result, part capital gain, part ordinary income, depending on the length of the period subsequent to various properties' completion. The possibility of this unusual treatment again is liable to result in dispute and consequent litigation.

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[6] 1954 IRC § 544; 1939 IRC § 503(a)(1), (2), (3), (5), (6).

[7] Reg. 118, § 39.117(m)-(1)(c)(3).

[8] Reg. 118, § 39.117(m)-(1)(c)(4).

It might be asked in passing whether an installment sale of corporate stock under Section 453, wherein the major portion of the gain is not "realized" until a future period subsequent to the three-year limitation, would suffice to remove that deferred portion from the statutory proscription. While no authoritative answer can be given, it is almost certain that the Bureau would resist this obvious effort to avoid the consequences of collapsibility. The contention could be made that for *such* purpose the gain was realized at the time of the original sale.[9]

3. The Method of Taxing Stockholders

Congress undoubtedly had several choices in combating the collapsible corporation device. The method which it chose was to tax as ordinary income in the hands of the shareholders what otherwise would be capital gains under Section 1201 (1954 Code), formerly 117(c).[10] The profit on the sale of stock or upon its redemption is treated as ordinary income, not as capital gain, thus defeating the purpose of collapsing the corporation. It follows that where there is no gain[11] or where there is a loss on the part of the affected shareholder, that the statute is inoperative. It is also obviously not part of the legislative plan to convert capital losses into ordinary losses, but only capital gains into ordinary income.

4. How to Avoid a Collapsible Act

A collapsible act may be avoided in a number of fashions. The methods lie largely but not entirely in the statutory limitations written into Section 117(m). If stock is held in a lesser percentage, if the collapse is delayed in time, if a substantial portion of the income attributable to the property has already been derived, the onus of the section is avoided by definition, but there are other less obvious methods.

a. Collapsible partnerships. Prior to the enactment of Section 751 of the Internal Revenue Code of 1954, where a collapsible corporation situation had been anticipated, the use, instead, of the collapsible partnership was possible. If the limited liability and other features afforded by a corporation were not controlling, a partnership could have been formed to produce the property. A sale of a partnership interest had been held to be a capital transaction.[12] The sale of their respective interests by all partners had been held to constitute a series of capital transactions.[13] The query might well have been raised whether this same capital-gain result would have followed if the purchasers of the partnership interest never intended to operate the partnership thereafter. If the partnership was liquidated forthwith, the door would be open to the claim by the Bureau that a sale of assets had occurred, in which event each type of asset would receive specific tax treatment.[14] The collapsible partnership method of avoiding collapsibility, if it is to be successful, should proceed by successive sales of partnership interests to new partners who will continue to operate the partnership business. Anything less will invite a Bureau challenge.

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[9] The nonacquiescence in *Susan J. Carter, et al.* (1947), 9 T.C. 364, aff'd (2 Cir. 1948), 170 F. 2d 911, in an analogous situation is an indication of the Bureau's probable attitude. The Commissioner there resisted capital gain treatment claimed by taxpayer on liquidation of a corporation, where the brokerage commission contracts distributed in liquidation could not be valued at such time, but only as future commission-income was earned.

[10] Amounts received in partial or complete liquidation are taxable under former Section 115(c) as amounts received, as upon a sale or exchange of shares, but they are not necessarily capital gains. See *Hay* v. *Commissioner* (4 Cir.), 145 F. 2d 1001, Sup. Ct. cert. den. 324 U.S. 863.

[11] Special rulings have been issued with respect to Section 112(b)(7). The portion of the liquidation which is nontaxable is not affected. Only the portion otherwise taxable as a capital gain is taxed as ordinary income. The portion of the liquidation taxed as ordinary income remains so taxed. The Special rulings with respect to that subsection are now changed. *See* Section 331 of the Revenue Act of 1951.

Section 751 of the Internal Revenue Code of 1954 helps to narrow the use of collapsible partnerships. It provides that the amounts received for the sale or exchange of a partnership interest attributable to (1) unrealized receivables of the partnership and (2) items of inventory which have appreciated substantially in value, will be treated as other than amounts realized upon a sale or exchange of capital assets. To this extent Section 741 allowing the capital gain (or loss) treatment on the sale of a partnership interest is superseded.

It would thus appear that Section 751 does not close the door entirely to collapsible partnerships but only to situations involving appreciated inventory and unrealized receivables.

b. Timing of the collapse. The collapsible charge can be avoided by careful timing of the three-year holding period. If that period is allowed to elapse from the date of completion of production, or from the time of the purchase of the property, Section 341 will not apply. The Regulations[15] indicate but do not actually state that where several properties have been produced or purchased, the three-year period runs separately for each such property. Since the tax is only upon the portion of the gain attributable to property produced or acquired in the three-year period, if the gain can be attributed successfully to the earliest acquired or produced properties, collapsibility can be circumvented. The difficulty will lie in the proper allocation of the total gain on sale of the stock or on liquidation to the various underlying corporate properties.[16]

c. Disposal of property. Another method of avoiding collapsibility is presented where a corporation owns several properties which would give rise to collapsibility. If one or more of these are disposed of by the corporation which *itself* might pay a capital gain on the profit under Section 1231 [formerly Section 117(j)], and the proceeds reinvested in securities or other assets not within the purview of Section 341, the corporation's own stock might then successfully be sold by the stockholders. The gain on such sale might not be attributable to the extent of the 70 per cent to the remaining assets classified as produced, manufactured, or purchased by the corporation. It is true that there would be a partial double tax, first in the corporation on the assets sold, and then on the shareholders when the stock is sold, but the amount of the tax in the corporation could be controlled by judicious selection of the specific assets to be sold. The ultimate gain on the disposal of the stock by the shareholders in liquidation or otherwise would be attributed at least to the extent of 31 per cent to assets other than those within the limits of collapsibility.[17] The total tax cost would be a capital gain of 26 per cent on the specific assets sold by the corporation itself, and a further capital gain to the extent that the value of the remaining assets of the corporation (as reduced by the tax on sale of the assets) exceeded the cost of the stock. The way is thus open at a limited increase in tax cost to avoid collapsibility by disposal of certain assets.

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[12] *Commissioner* v. *Lehman* (2 Cir.-1948), 165 F. 2d 383, cert. den. 332 U.S. 808; *Commissioner* v. *Shapiro* (6 Cir.-1942), 125 F. 2d 532; *Long* v. *Commissioner* (5 Cir.-1949), 173 F. 2d 471, cert. den. 338 U.S. 817; *Commissioner* v. *Smith* (5 Cir.-1949), 173 F. 2d 470, cert. den. Oct. 10, 1949.

[13] *Luhrs et al.*, T.C. Memo. Op. (9 T.C.M. 537).

[14] See *Williams* v. *McGowan* (2 Cir.-1946), 152 F. (2d) 570. See also *Estate of Herbert B. Hatch* v. *Commissioner* (9 Cir.-1952), 198 F. 2d 26.

[15] Reg. 118, § 39.117(m)-1(c)(4).

[16] If the aggregate of the properties constitute a single unit this method of avoiding § 341 cannot be used safely. See Proposed Regulations § 1.341-5(b)5.

d. Section 333 type liquidation. Section 112(b)(7), which had permitted liquidation of corporations during one calendar month during the years 1950 and 1951 has been re-enacted as Section 333 of the Internal Revenue Code of 1954 and made permanent. There was considerable doubt whether liquidations under Section 112(b)(7) were controlled by the then Section 117(m). The re-enactment of Section 112(b)(7) in 1951 after the enactment of Section 117(m) in 1950 gave rise to a doubt as to whether Congress was prepared to permit this type of liquidation.[18] Section 112(b)(7) had permitted the liquidation of a corporation taxing the receipt of the earnings and profits as ordinary income. If the sole "profit" lay in the appreciation of an asset and the corporation had no earnings and profits, the stockholder was permitted to postpone the tax effect of the increase in value. This was the precise situation confronting stockholders about to collapse a corporation *before* it had earnings and a consequent surplus. The Senate Finance Committee was aware of this situation and the new Code specifically provides at the very outset of Section 333 that that section should not be available to collapsible corporations within the meaning of Section 341(a). Doubt is thus resolved. The same is true of sales or exchanges otherwise treated as nontaxable to the corporation under Section 337, which was designed to clarify the problems raised in *Commissioner* v. *Court Holding Company*[19] and *U.S.* v. *Cumberland Public Service Co.*[20]

e. Realization of income. The statute provides that substantial realization of income from the property produced or acquired takes the corporation out of the collapsible category. Certain types of property can be exploited in such a fashion that a substantial portion of the income will be realized up to a given point in time.[21] The property will then be permitted to become dormant. Thereafter a sale of the corporate stock could be effected without the charge of collapsibility, but at a price which would reflect a future value if the new holders of the stock were to reactivate the property. Thus a patented property developed by a corporation could be exploited in a limited market on a pilot basis. All of the income from the limited operation (i.e., more than a substantial portion) would be reported. The patent would be allowed to lie dormant for a year, for the reason that the shareholders lacked the funds or ability to exploit the patent on a national basis. Then the corporate stock would be sold by the shareholders at a price which would recognize the fact that the patent could be exploited in a much larger market by proper promotional activity. The Commissioner might find it hard to apply Section 341 in such a case merely because the original stockholders of a corporation did not themselves elect to invest and expend large sums of money at a given time to popularize a patent. Is the word "substantial" to be read in conjunction with what someone else can do, or what the present stockholders can do? The later view is preferable.

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[17] Proposed Regulations § 1.341-5(d)III example (2) may be an improper interpretation of § 341(d)(2). It would break down the total profit on the sale of corporate stock among the various assets sold, treating the portion of the gain attributable to certain collapsible assets as ordinary income, even though more than 30% of the total gain on the sale of the stock is attributable to non-collapsible assets.

[18] Freeman, Lionel J. *op. cit.*, footnote 4. Norman S. Schlesinger, "The Collapsible Corporation through the Looking Glass," *Taxes*, November 1951, page 895.

[19] 324 U.S. 451.

[20] 338 U.S. 341.

[21] E.g., property manufactured and completely covered by patents.

f. Disposal of stock interest. The vulnerable stockholder today is one who owns 5 per cent or more of the value of the outstanding stock of the corporation.[22] If a stockholder can dispose of stock in such a way as not to give rise to gross income, so as to bring his holdings to less than the requisite 5 per cent, he may thereafter sell or otherwise dispose of his remaining stock without incurring liability to tax treatment under Section 341. A taxpayer in high surtax brackets, owning, for example, 10 per cent of the outstanding value of corporate stock, might find tax saving possible by giving more than 5 per cent of the corporate stock to a charitable foundation, before he sells the balance. The charitable deduction plus the capital-gains treatment afforded the balance of the stock could easily be less costly tax-wise than the receipt of ordinary income on the sale of the 10 per cent under Section 341.

5. Conclusion

Section 341, as first enacted in 1950, amended in 1951 and revised in 1954 is comparatively new legislation. The vagueness of draftsmanship must stand as a warning to taxpayers until such time as the Courts and the Commissioner of Internal Revenue have had frequent occasions to narrow and define its scope more closely. The amendments to the law contained in the 1954 Code do not supply the answers.

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[22] § 117(m)(3)(A). The language used in this section: "owned (or was considered to own)."

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How to Do Business in Foreign Countries

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Many sections of the law—and a host of decisions—point the way to the best manner of organizing for business abroad. Study of these afford considerable opportunity for full control of the tax consequences.

1. Points to Consider

You want to trade abroad.[1] You are faced with finding the most satisfactory tax position. Your first problem will concern itself with questions like these:

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These are essential points for study when you start out to do business taxwise abroad.

2. Companies That May Be Used

You may, of course, use your own company to trade in foreign countries. Then you pay a tax on the income from business abroad, just as you do on any income.[2] But there are three other types of companies generally used:

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[1] There is no effort made to discuss here the many considerations other than taxes that may lead to one form of doing business as against another. They may be the governing factors in making the decisions. You can obtain a good deal of information on foreign operations from the United States Department of Commerce.

[2] Reg. 118, § 39.13-1.

Description	Place of Doing Business
Foreign Corporations. They are corporations organized in a foreign country doing business in foreign countries.	Anywhere in the world.
Western Hemisphere Corporations. They are corporations organized in U.S. to do all their business in the Western Hemisphere.[3]	Anywhere in the Western Hemisphere: in North, Central, or South America or in the West Indies.
Possession Corporations. They are corporations organized in U.S. doing business in a U.S. possession.	Only in the Canal Zone,[4] Guam, American Samoa, Wake Island, Midway Island, the Johnson Islands, and in many of the small islands in the Pacific Ocean.

Taxes payable by these three types of companies are as follows:

Foreign Corporations. You pay no tax on income from the foreign business.[5] You pay a tax only if engaged in trade or business in the United States and then only on income from sources within the United States.[6] The tax rate is the same as that imposed on a domestic corporation. If there are no manufacturing or like activities in the United States[7] and sales are conducted abroad, then no gross income is from the United States.[8] Investment income from United States sources is taxed in any event,[9] except profits from sales of stock if your corporation is not engaged in business in the United States.[10]

Western Hemisphere Corporations. These corporations pay the normal tax and surtax.[11] But they then get a 27 per cent credit of their normal tax net income against both normal and surtax net income[12] if (1) 95 per cent or more of the gross income for the three-year period immediately preceding the close of the year (or for the part of the period of existence)[13] was derived from sources outside the United States and if (2) 90 per cent[14] or more of the gross income for that period was derived from the active conduct of a trade or business.

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[3] 1954 IRC § 921; 1939 IRC § 109 requires that the entire trade or business of an exempt corporation be carried on in the Americas or adjacent areas. But incidental economic contact with other countries outside this geographical sphere will not place corporations outside the exempt classification.

[4] It is possible that a company might qualify under this section and also under 1954 IRC § 921; 1939 IRC § 109 if more than 95 per cent of its gross income comes from Puerto Rico or the Canal Zone. Whether the sections are mutually exclusive is in doubt. See George S. Allan and Sidney S. Coggan, "Tax Planning for Foreign Trade," *Tax Law Review*, 1947, Vol. 3, page 45; see also, Harry J. Rudick and George S. Allan, "Tax Aspects of Operations under the Puerto Rican Exemption Program," *Tax Law Review*, 1952, Vol. 7, footnote 74 on page 417.

[5] Foreign corporations pay a tax under 1954 IRC §§ 881(a) or 882(a); 1939 IRC § 231(a) or 231(b), or not at all.

[6] 1954 IRC § 882(b); 1939 IRC § 231(c).

[7] 1954 IRC §§ 881(a) and 871(a); 1939 IRC §§ 231(a) and 211(b).

[8] 1954 IRC § 862(a) and (b); 1939 IRC § 119(c) and (d).

[9] 1954 IRC §§ 861(a)(1) and (2), 881(a); 1939 IRC §§ 119(a)(1) and (2), 231(a)(1).

[10] 1954 IRC § 871(c); 1939 IRC § 211(b).

[11] The taxes imposed by 1954 IRC § 11; 1939 IRC §§ 13 and 15.

[12] Prior to January 1, 1954, there was a reduction of normal tax income by a credit of 28 per cent for 1951 and 27 per cent thereafter, as well as a full exemption from the excess profits tax. From and after January 1, 1954, the "credit" has been continued in effect by the Section 922 Special Deduction. This deduction is computed as follows:

"(1) First determine the taxable income of such corporation without regard to this section.
(2) Then multiply the amount determined under paragraph (1) by the fraction—
  (A) the numerator of which is 14 per cent, and
  (B) the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate prescribed by Section 11."

Under Section 11 the normal tax and surtax rates total 52 per cent; divide that figure into 14 per cent and the result is 26.923 per cent—substantially the equivalent of the 27 per cent credit allowed prior to the 1954 Code.

The Western Hemisphere exemption was intended by Congress to aid United States firms selling goods made in the United States to customers in other countries of the Western Hemisphere.

For 1954, these corporations were taxed at a maximum of about 38 per cent.

Possession Corporations. You are treated as a foreign corporation. You pay a tax only on the net income received in or derived from sources within the United States[15] and if you meet the tests. They require that: 80 per cent or more of gross income for three years before the close of year (or for the period of operations in a possession[16] if that is less than three years) comes from sources within a United States possession[17] and that 50 per cent or more of gross income comes from active conduct of a trade or business within a United States possession.

China Trade Corporation. The chaotic conditions in China probably make a discussion of business operations there academic.

However, the Internal Revenue Code of 1954 still recognizes the existence of corporations which were organized under the China Trade Act of 1922. Such corporations may still get a special deduction under Code Section 941, formerly Code Section 262(a) and (b), against the tax imposed by Code section 11 on taxable income derived from Formosa and Hong Kong (but no longer China). The section 941 "special deduction" is based on the ratio of the par value stock owned by citizens or residents of the United States, residents of Formosa and Hong Kong or residents of U.S. possessions, to the total par value of all stock outstanding. This special deduction is limited by a "special dividend" distributed to stockholders and certified to the Commissioner of Internal Revenue by the Secretary of Commerce. Full normal and surtaxes are paid on any taxable income above the amount of the special deduction.

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[13] It may be necessary to form a new corporation in view of the three-year period. A manufacturing company may have real problems in qualifying since its income undoubtedly comes from manufacturing. A new sales company might help. Or perhaps manufacturing outside the United States may be warranted. How to trade in the hemisphere will also present many problems. It may be necessary to set up agencies and storage facilities in the foreign country. 1954 IRC § 921; 1939 IRC § 109.

[14] A severe deflation of prices in the future may reduce the corporation's income to a point where investment income is more than 10 per cent. It is advisable not to have too much income from investments in securities.

[15] 1954 IRC § 931; 1939 IRC § 251. If the income is received outside the United States and later—even in the same year—it is transferred to the United States, the exemption still applies. I.T. 3348, 1940-1 C.B. 93. But if the proceeds of the sale are transmitted directly to the United States, it would be received within the United States and included in gross income. Reg. 118, § 39.251(b)-1.

[16] The 80 per cent of gross income must come from one country only. The Western Hemisphere Corporation rule does not restrict the income to one country.

[17] If a company has substantial income from investments in the United States, it runs a grave risk of being a personal holding company. That can happen because gross income is income derived in the United States only, rather than gross income from all sources. *Porto Rico Coal Co.* v. *Commissioner* (2 Cir. 1942), 126 F. 2d 212, 28 AFTR 1316. *See also* Harry J. Rudick, "Personal Holding Companies Owned by Nonresident Aliens," *Tax Law Review*, 1945, Vol. 2, page 218.

Five other matters are just as important as corporate tax rates. They are covered in the following table.

Company	If Your Company Is		
	Foreign Corporation	Western Hemisphere Corporation	Possession Corporation
1. Can you avoid the Section 531 tax on unreasonable accumulations even when earnings are unnecessarily accumulated?	Yes, as to foreign income[18]	No[19]	Yes, as to possession income[20]
2. Do you get credit under Section 901 for foreign taxes paid?	Domestic corporation owning at least 10 per cent of the company's voting stock gets the credit[21]	Yes[22]	Domestic corporation owning at least 10 per cent of the company's voting stock gets the credit[23]
3. Does the domestic parent get a dividend-received deduction under Section 243?	Yes, under certain conditions[24]	Yes[25]	No[26]
4. May the company be a member of an affiliated group for purposes of filing a consolidated return?[27]	No, unless 100 per cent owned subsidiary of Canada or Mexico	Yes	No
5. Can you liquidate tax free into domestic parent under Section 332(a)?[28]	No, unless you prove prior to exchange that one of the purposes is not avoidance of taxes	Yes	Yes

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[18] If sales activities are transacted in such a way that the company's income is realized abroad and that there are no manufacturing or like activities in the United States, there is no gross income from United States sources. If there is no income from within the United States, there is no base for the imposition of the normal tax, surtax, or 1954 IRC § 531 (1939 IRC § 102) tax.

[19] A Western Hemisphere Trade company is a domestic corporation. It is not exempt from the 1954 IRC § 532 (1939 IRC § 102) tax.

[20] The Code treats this type of corporation almost identically as it treats a foreign company. Only income from United States sources pays the normal tax, surtax, and 1954 IRC § 531 (1939 IRC § 102) tax.

[21] A domestic corporation that owns at least 10 per cent of the voting stock of a foreign country from which it receives dividends in any year is allowed the credit. 1954 IRC § 902(a); 1939 IRC § 131(f)(1).

[22] 1954 IRC § 901; 1939 IRC § 131(a)(1). The credit is not allowed in computing the section 531 tax.

[23] *See* footnote 21, above.

[24] Only dividends from a domestic corporation get the dividend-received deduction. 1954 IRC §§ 245, 246; 1939 IRC § 26(b).

[25] A section 921 company comes within the provisions of 1954 IRC § 243(a); 1939 IRC § 26(b) and its domestic parent is entitled to the dividend-receive deduction.

[26] Express language in 1954 IRC § 246(a) (1939 IRC § 26(b)) excludes the allowance of this deduction to 1954 IRC §§ 931 and 934 (1939 IRC §§ 251 and 261) companies.

[27] 1954 IRC § 1504(b); 1939 IRC § 141(e) in defining includable corporations for the purpose of filing consolidated returns specifically excludes foreign corporations.

If a Western Hemisphere Corporation is part of an affiliated group filing a consolidated return.

3. Which Type of Company Is Best?

Sears, Roebuck and Company has invested some $22,500,000 in its Latin-American stores. In 1943 foreign sales were below $2,000,000. In 1950 they were up to $42,000,000. The Latin-American subsidiaries (all foreign corporations) pay a corporate tax to the countries in which they operate. But the rates are usually much lower than ours. There is no U.S. tax on this income when it is earned. So the money can go back into expansion if it's kept in the foreign corporation in South America. That's what Sears is doing.

After a few years of building up capital values and earning power, the net will be worthwhile to U.S. stockholders even after U.S. taxes. When the income is brought into the U.S., Sears has to pay normal tax and surtax, but it gets a credit for foreign taxes already paid. That's one way to approach this subject.

Parke-Davis and Company took another route. It created a Western Hemisphere subsidiary to carry on its south-of-the-border operations. Income will be subject to U.S. normal tax and surtax, but a credit of 27 per cent is allowed. Colon, Panama was selected as headquarters because it has a free zone through which goods may be shipped or transshipped free of duties, sells land on attractive terms, constructs warehouses for rent and provides commercial space free of tax except for the Panama income tax at rates from 2 to 16 per cent.

Which gives the greater benefits—the formation of a foreign subsidiary or a Western Hemisphere corporation?

We have already described the three general forms of companies available for business—the Foreign, Western Hemisphere, and the Possessions corporations. Other than the places where these corporations may do business, the manner of taxing their income, and the rates of taxation, it is to be observed that:

1. Foreign and Possessions corporations are almost alike in tax treatment, except in dividend-received deductions, and rights to affiliate.

2. Only the Western Hemisphere companies and the Possessions companies have the right to liquidate into their parents without tax. In Foreign corporations, consent of the government must be secured to do that and consent is not always obtainable.

3. The Western Hemisphere companies are almost like ordinary domestic corporations; you retain full right to affiliate, full dividend deduction, full exemption from tax in event of a tax-free liquidation made in the normal way.

Much of our business controversy about trading abroad today is this: Which is best for me—the Foreign corporation or the Western Hemisphere company?

That comes only in an examination of the manner in which companies are set

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the two per cent additional tax on consolidated returns does not apply to that part of the consolidated income which belongs to the Western Hemisphere Corporation. 1954 IRC § 1503(b); 1939 IRC § 141(c), as amended by the Revenue Act of 1950.

[28] 1954 IRC § 332; 1939 IRC § 112(b)(6) excludes realization of gain or loss "upon a receipt by a corporation of property distributed in complete liquidation of another corporation." There is no requirement that either company be a domestic corporation. The only possible limitation is in 1954 IRC § 367; 1939 IRC § 112(i) and that is for foreign subsidiaries only. The Commissioner must be satisfied that the liquidation is not a tax avoidance scheme when the liquidation of a foreign subsidiary follows the question of foreign business. No difficulty should be had for a tax-free liquidation.

up to handle business in the Western Hemisphere. The following table aids in your decision of the advantages, apart from the tax calculation:

WHEN TO USE A FOREIGN OR WESTERN HEMISPHERE CORPORATION

Use Foreign Corporation	Use Western Hemisphere Corporation
If you are not worried about losses of parent or the subsidiary—so you do not care about affiliation with a loss. (Note that this does not affect a Canadian or Mexican Company.) When you do not care about a tax-free liquidation in the event you give up the business. (But you can be tax free in liquidating a Possessions company.) When the dividend-received deduction is not important (it is severely confined in these companies). When there is a ticklish question about where income arises or where title to sales passes; use of the Foreign or Possessions corporation might avoid danger in most cases. If the bulk of the products are to be consigned by the company (as a manufacturer) to the U.S. (Use of the Foreign company is then more natural than use of a Western Hemisphere company in order to avoid questions as to where title passes.) Where you are likely to have questions about price used in intercompany dealings or intercompany overhead matters. Where you do not have the Foreign company domiciled in the U.S. for its tax purposes. You have no tangible property, no office or mailing address, no employees here. You run the office from the foreign country, and hold all directors' meetings there. Where you are attempting to qualify under a special program of tax exemption, as for example, in Puerto Rico.[29]	When you want to preserve right to affiliate in the event of a loss in one of the companies. When you want to be sure you can liquidate the business into your corporation without tax. And where more than 80 per cent of sales are made to Western Hemisphere countries, and title passes there, you might use this kind of company.

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[29] What is practically a tax-free "holiday" for a limited period is possible for both United States and Puerto Rican companies because of these special factors: (1) Puerto Rican residents and corporations are not subject to the United States income tax; and (2) Puerto Rico through its exemption statutes provides for exemption from all major taxes to certain qualified industries as well as the exclusion of distributed corporate earnings from individual income tax.

The greatest possible benefits are obtained through the use of a Puerto Rican corporation. Where you intend to sell your products to the United States markets, it might be hazardous to use a United States corporation. Even though title to merchandise is passed in Puerto Rico, the United States government might allocate a substantial portion of the profits from

Tax rates in the foreign country are important. Assuming that you are not bothered by a failure to distribute dividends of a Foreign corporation (where you do not get the 85 per cent deduction) you will have a simple problem; your foreign country is a better source of new income if its tax rate is below 38 per cent. If it is less, you'll pay less, since the Western Hemisphere corporation pays 38 per cent.

But, assuming that you'll want to pay out all income, use the following table to find which is better:

Foreign Tax (per cent)	Total Tax on Profits		You Ought to Use
	For Western Hemisphere Corp. (per cent)	For Foreign Corp. (per cent)	
0	42.8	52	W.H.*
10	42.8	47.8	W.H.
20	42.8	45.6	W.H.
30	42.8	45.4	W.H.
40	44.7	47.2	W.H.
50	53.9	51	F.C.†
60	63.1	60	F.C.
70	72.3	70	F.C.
80	81.6	80	F.C.

* Western Hemisphere Corporation.
† Foreign Corporation.

In some foreign countries there is a withholding tax on the dividend paid out by a subsidiary. The following table can guide you to selection:

Where the Foreign Tax on the Subsidiary Is (per cent)	Use a Western Hemisphere Corp.	Use a Foreign Corp.
10	If withholding tax is less than 16 per cent	If withholding tax is more than 16 per cent
20-30	If withholding tax is 12 per cent or less	If withholding tax is more than 12 per cent
40	Regardless of the withholding rate	
50-70	If withholding tax is more than about 8 per cent	If withholding tax is less than about 8 per cent

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sources within the United States under 1954 IRC § 863(b). This would destroy any attempt to qualify the United States corporation either as a Western Hemisphere Trade corporation under 1954 IRC § 921 or a Possessions corporation under 1954 IRC § 931.

The use of a Puerto Rican corporation will avoid such dangers. Your profits are entirely free from United States tax if: (1) you pass title to the merchandise in Puerto Rico; (2) you act so as not to be "engaged in business in the United States" inasmuch as a Puerto Rican corporation is a foreign corporation as defined by 1954 IRC § 7701(a)(4), (5) and (9).

On this special aspect of foreign trade see Rudick, Harry J. and Allan, George S., "Tax Aspects of Operations Under the Puerto Rican Exemption Program," *Tax Law Review*, May 1952, Vol. 7, page 403, as well as Act No. 184 of May 13, 1948 and Act No. 6 of December 15, 1953, of Puerto Rico.

4. Foreign Branch or Company?

So far we have talked only of the tax distinctions between the various types of companies available. Maybe you do not want a new company; maybe a division of your own company can do the job? If you think in those terms, the following chart will be helpful:

FOREIGN BRANCH OR FOREIGN LOCAL CORPORATION?

Branch	Local Corporation
When a loss is expected, the full amount can be deducted from the United States company's earnings. When a profit is expected and foreign taxes are higher than United States taxes. Total taxes may be the same with a branch or subsidiary if the subsidiary paid out dividends. When there is a profit and United States taxes are higher than those in the foreign country, total taxes can be higher with a branch office. Remember, too, that the branch's income would be part of the United States income, in which case you pay all United States taxes including Section 531 tax.	When foreign operations are profitable it is generally better to have a local corporation, especially if the foreign country's taxes are lower than the United States taxes.[30] If the United States tax rate is higher, total taxes are less because only the local corporation's dividends would be reported. Foreign profits can be transferred to the domestic company or accumulated there for further investment without fear of Section 531. Dividends from foreign company can be used to increase income of the United States parent. Foreign profits can be transferred to parent in a year when it has losses. Local taxes can often be minimized if you are certain that the local corporation will be treated as a separate entity for tax purposes.[31] Earnings of one branch of a local corporation in a country having no corporation tax can be used to finance branches in another foreign country.[32]

Other methods may be used when a branch or wholly-owned subsidiary is not advisable:

1. Conducting the business in various foreign countries through branches of a subsidiary in a country imposing no effective corporate income tax. The profits can be accumulated and reinvested free from United States tax.

2. Conducting foreign activities through a branch of a pre-existing foreign subsidiary rather than through a branch of the American parent company. In many

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[30] It is essential to understand the foreign tax system. Sometimes the foreign country has a double tax that applies against an American branch that would not apply to a foreign corporation.

[31] See discussion of 1954 IRC § 482; 1939 IRC § 45, § 9 of this chapter, below.

[32] This transaction, if between a United States company and a foreign subsidiary, might, of course, be treated as a taxable dividend by the Internal Revenue Service.

foreign countries, a nonresident corporation may carry on business by means of an "agency," as distinguished from a branch, without subjecting itself to any tax in the foreign country. In this sense, "agency" may imply an individual or firm comparable to an independent broker.

3. Setting up a holding company (as a subsidiary) in a country having no income tax. This allows the accumulation outside the United States of the earnings of the foreign subsidiaries. The fund can be used for the financing of aid for expansion into other foreign fields.

5. Who Should Own the Stock of a New Company?

If it is important to be able to dissolve the company doing business abroad without paying tax, corporation ownership of the stock is best in most cases.[33] But even if you have individual ownership, the tax is only 25 per cent of the gain,[34] if the stock has been held for more than six months.

If your company is doing business abroad and its stock is owned by individuals, you may have to worry about the Section 531 tax. Perhaps you should have a foreign corporation if you want the stock to be owned by individuals. If your company is doing business abroad, and is a foreign corporation with no United States income, or a Possessions corporation, it cannot be taxed on unreasonable accumulations, whether owned by individuals or a parent.

In determining whether the parent has unreasonably accumulated surplus, surplus funds of its subsidiary are relevant. If there is individual ownership of the foreign corporation, there is no possibility of such tax to the domestic corporation.[35]

Dividends are almost completely freed from tax when paid by one company to other companies.[36] But they would be taxed if paid to individuals.[37] Does that matter in your planning? A transfer of assets of uncertain market value from one company to a foreign corporation, both controlled by the same individuals, might result in constructive dividends.

If the stock of a foreign corporation is individually owned, the estate of a deceased stockholder may be subject to inheritance tax in the foreign country of organization.[38] Check the country in question to see what the cost will be. If the cost bars individual ownership, see whether you want a domestic company interposed between the individuals and the foreign company.

Estate planners are often interested in direct ownership of foreign businesses holding real estate. No Federal estate tax is due on real estate situated outside the United States.[39] A dealer, seeking American capital, offered three properties in the heart of Caracas. One yields a net of 14 per cent, the other two promise to return 12 per cent net. The dealer emphasizes that appreciation in value makes the real estate "a very good investment for heirs." The property can be passed on to them free of U.S. estate tax. The heirs can sell the property and convert to American dollars.

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[33] *See* footnote 28, above.

[34] 1954 IRC § 1261; 1939 IRC § 117(c)(2).

[35] *See* footnotes 18, 19, 20, above.

[36] *See* footnotes 24, 25, 26 and 27, above.

[37] 1954 IRC §§ 61 and 301; 1939 IRC §§ 22(a) and 115.

[38] Under special estate tax treaties with Great Britain and Canada and proposed with France and the Union of South Africa, credit is allowed for this tax against the United States estate tax.

[39] 1954 IRC § 2031(a); 1939 IRC § 811.

You should study the tax rates in the countries in which you intend to do business. Some countries give a credit for foreign taxes paid.[40] On the other hand, the foreign taxes may be less than our combined normal and surtaxes. Then the advantage is with the foreign company.

Do you think that your United States company will need cash in the future? If so, then individual ownership of the stock of the foreign company will subject the cash passing through the stockholders to the United States company to individual surtax. Company ownership of the stock, on the other hand, would cause only 15 per cent of the cash to be subject to tax, or if it is all taxed, then you receive a credit for foreign taxes paid.[41]

Do you think the foreign company will need cash in the future? If so, stock ownership by a domestic company will be more advantageous from the point of view of Section 531. If high profits are expected, the domestic company's position under 531 will be less advantageous.

If there is any possibility of your company losing money, perhaps you will want to consolidate the company doing business abroad with your American company in order to take the loss this year. If so, note the instances in which you can consolidate profits and losses.[42]

6. How to Get Money Out of These Companies

Getting ordinary dividends out of a Western Hemisphere company to another corporation is simple. You owe a tax on only (roughly) 15 per cent of the dividend.[43]

But the Foreign corporation's[44] and the Possessions company's[45] dividends are usually subject to the full tax. You then get the tax credit. You are up against a stiff U.S. tax to get out ordinary dividends. And yet the net out-of-pocket costs can be less than in operating a Western Hemisphere corporation, counting the U.S. taxes you might have to pay ordinarily on the corporate income and on the intercorporate dividends. All this is easy to figure in each case.

How else can you get money out of a foreign company? Moving (fully, or in part) out of the Western Hemisphere company is simple for the average corporate parent. A liquidation is tax free.[46] But that is not always true of the foreign company.[47] There, American companies use these mechanics:

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[40] See Section 12 of this chapter, below.

[41] A domestic company which owns at least 10 per cent of the voting stock of a foreign company is allowed a credit for the foreign taxes paid by the subsidiary. The credit is extended to a foreign subsidiary of a foreign subsidiary if the second company's stock is at least 50 per cent owned by the first subsidiary. An individual stockholder of a foreign corporation does not receive a credit for foreign taxes paid by the foreign company. 1954 IRC § 902; 1939 IRC § 131(f). *See* Section 12 of this chapter, below.

[42] 1954 IRC § 1504(a), (b); 1939 IRC § 141(d), (e).

[43] *See* footnote 25, above.

[44] *See* footnote 24, above.

[45] *See* footnote 26, above.

[46] *See* footnote 28, above.

[47] *See* footnote 28, above.

1. Property is turned over to these companies subject to loans or mortgages obtained from bankers or others in the U.S. Then they are paid off to the creditors by the Foreign company. In the interim, the parent has the full use of the funds.

2. Property is sold to the subsidiary at fair value subject to obligations to the parent. Or the new company is created with obligations in a tax-free transfer approved by the government under the reorganization provisions. Then the obligations are paid off in due course without tax to the parent or the subsidiary. This may include redemption of bonds created by the parent upon the subsidiary when it was organized.

3. Capital gains taxes are paid to the U.S. on the full liquidation of the subsidiary. This income is not again subject to the Section 531 tax in the U.S. That was cleared up by an amendment to the tax law in 1951.[48] Prior to that, it was a difficult problem for companies desiring liquidations.

4. Part or all of the stock in the foreign company might be sold here or abroad. Sometimes sales are to other corporations for approximately the liquidating value. Then the new parent can effect the liquidation, and take the proceeds tax free. That process moves on the assumption that the sales price would be the value received in the dissolution.

7. How to Make Sure You Pass Title Abroad

When you sell goods abroad, *all* of the profit is foreign source income, with one exception: If you manufacture or process the goods in this country, the income is partly from United States sources and partly from foreign sources.[49]

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[48] 1954 IRC § 535(b)(6); 1939 IRC § 102(d)(1)(D).

[49] 1954 IRC § 863(b); 1939 IRC § 119(e). The effect of the statute is to divide the source of income from sales of personal property into three groups:

1. All income is from U.S. sources where: The sale is made inside the U.S. by a seller who had produced the property in the U.S. or had bought it in or outside the U.S. but not in a possession.

2. All income is from foreign sources where: The sale is made outside the U.S. by a seller who had produced the property outside the U.S. or had bought it in or outside the U.S.

3. Income is partly from U.S. sources and partly from foreign sources where: The property is produced by the seller outside the U.S. and sold inside the U.S.; or produced inside the U.S. and sold outside the U.S.; or bought in a possession and sold in the U.S.

In Group 3 you allocate income to each source according to the following rules:

1. If you can fix separate production and selling prices and your factory is in a different country from the selling department, then allocate income to each source based on the two prices.

2. If you cannot follow Rule 1, compute net income from transactions. Where the apportionment is between the U.S. and a foreign country, use the following formula:

$$\tfrac{1}{2}\text{ Net Income} \times \frac{\text{Value of your property in the U.S.}}{\text{Value of your property in the U.S. and the foreign country}}$$

PLUS

$$\tfrac{1}{2}\text{ Net Income} \times \frac{\text{Your gross sales within the U.S.}}{\text{Your gross sales within the U.S. and the foreign country}}$$

Where the apportionment is between the U.S. and a possession, use the following formula:

$$\tfrac{1}{2}\text{ Net Income} \times \frac{\text{Value of your property in the U.S.}}{\text{Value of your property in the U.S. and the possession}}$$

PLUS

$$\tfrac{1}{2}\text{ Net Income} \times \frac{\text{Amount of your business in the U.S.}}{\text{Amount of your business within the U.S. and the possession}}$$

The term "business" as used here means the amount you paid out for employer's compensa-

To complete a sale outside the United States, beneficial title and risk of loss[50] must pass in a foreign country; retention of bare legal title as security does not impair transfer of ownership. Use this table in preparing your deals.

How to Pass Title Abroad

Do the Following If You Ship from U.S.	Do the Following If You Ship from Abroad
Create your own foreign branch and ship the merchandise there for resale. (Make sure the branch registers abroad; check the local taxes on this method of operating.) Consign to an agent abroad. You can hold title until the foreign customer takes delivery. Then you require the foreign customer to pay by draft before delivery. (Again, check foreign laws to find local regulations and taxes on this setup.) Best set up a new corporation and sell your products to it in the United States for resale abroad. The income of the new corporation (which should be the equivalent of a distributor's profit) would be from sources outside the United States. Ship consigned merchandise C.I.F. Under a C.I.F. contract, the agreed price includes insurance and freight on the goods to the point of destination. Ship consigned merchandise F.O.B. port of destination. Under an F.O.B. contract, the agreed price includes all charges for packing, loading, etc. incident to delivering the goods "free on board" to the designated point. Pass beneficial ownership *and risk of loss* to the purchaser at the port of shipment.	Consign the goods F.O.B. the foreign port. Ship the goods to a branch for later sale to the foreign customers. Consign the goods to an agent in the foreign country for delivery to the foreign customer. By using either of the last two methods, check the laws of the foreign country to determine the extent, if any, to which you would be liable there for taxes. You would be subject to a foreign income tax, and it would be wholly or partially absorbed by the foreign tax credit against your U.S. tax, depending on whether the foreign tax rate is lower or higher than the effective U.S. tax rate. But no such absorption would occur if the foreign tax were other than "income, war profits or excess profits" tax.

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tion, for purchase of goods and materials consumed in the regular course of business plus the amounts received from gross sales.

3. In all cases, the books of the company will be used if they more clearly indicate income derived from sources within the U.S. But the books must be kept in good faith and not with the purpose of reducing taxes by means of incorrect allocations. Reg. 118, § 39.119(e)-1.

[50] G.C.M. 25131, 1947-2 C.B. 85.

Since passage of beneficial ownership and risk of loss governs in determining where a sale is consummated, the following factors are not of controlling importance: The place where the contract of sale is made or executed, or the order placed or accepted; the place of payment; the residence of the buyer; the fact that a foreign seller maintains sales agents in the U.S. who solicit orders. But the Treasury warns in G.C.M. 25131 that if the sale is arranged in a particular manner for the primary purpose of tax avoidance, all the details of the transaction will be considered and the title-passage rule may be ignored. The validity of this caveat is doubtful since our courts accept the place in which beneficial ownership passes as creating the place of sale. *East Coast Oil Co.*, S.A., 31 B.T.A. 558, affirmed (5 Cir. 1936), 85 F. (2d) 322, 18 AFTR 446, cert. den. 299 U.S. 608 (1936); *Ronrico Corporation*, 44 B.T.A. 1130 (1941); *Exolon Co.*, 45 B.T.A. 844 (1941). *See Compania General de Tobacos de Filipinos* v. *Collector of Internal Revenue*, 279 U.S. 306, 7 AFTR 8858 (1929).

8. How to Get Your Gross Income from Foreign Countries

If you are seeking to qualify a business as entitled to the tax cut as a Foreign, Western Hemisphere or Possessions corporation, you have to understand the rules.

Requirements to Qualify for Exemptions

Types of Corporations	Requirements
Foreign Corporation	No sales or sources of income in this country; no manufacturing here.
Western Hemisphere Corporation	95 per cent of gross income for three year period immediately preceding the close of the year (or part of, for the part of the year of existence) was derived from sources out of the U.S.—and 90 per cent or more of the gross income for that period was derived from an active trade or business.[51]
Possessions Corporation	80 per cent of the gross income for three years before close of the year (or period of operation in the possessions if that is less than three years) comes from sources within a U.S. possession, and 50 per cent of the gross income comes from active conduct of the business within a U.S. possession.[52]

Foreign corporations are taxed on United States sources of income (except their investments) only if "engaged in business in the United States." [53]

So where you are engaged in business becomes important. What sets you up as doing business here? Follow this table for a guide:

Evidences of Doing Business in U.S.	Evidences of Not Doing Business in U.S.
Keeping an office in the U.S. is evidence of doing business, but not conclusive.[54]	You have no office, tangible property or mailing address here.
Qualifying to do business in one of the states bears weight.[55]	Selling outright to a United States parent or affiliate for resale, but avoiding an agency relationship.
Using agents or employees here who are	

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[51] *See* footnote 3, above.

[52] *See* footnotes 15, 16, and 17, above.

[53] *See* footnote 6, above.

[54] Before 1942 one of the criteria of residence status for a foreign corporation was whether it maintained an "office or place of business" here. This criterion was eliminated by the Revenue Act of 1942.

The operation of an office in the United States by a foreign corporation solely for the purpose of collecting investment income such as dividends and interest does not constitute doing business here. *Scottish-American Investment Co., Ltd.*, 12 T.C. 49 (1949); *Linen Thread Co., Ltd.*, 14 T.C. 725 (1950).

[55] *Investors' Mortgage Security Co., Ltd.*, 4 T.C.M. 45.

Evidences of Doing Business in U.S.	Evidences of Not Doing Business in U.S.
regularly engaged in profit-seeking activities on your behalf. Marketing your merchandise in the U.S. may be doing business here—even though title may pass in the foreign port. If done by employees or sales agents[56] or by a U.S. parent or affiliate on your behalf, you may be engaged in U.S. business. The best way is to sell outright to distributors. Performing services in the U.S., such as the installation or servicing of machinery.[57] Keeping your records here with a U.S. parent or affiliate. Using paid officers of parent or affiliate as your officers. Having a full time officer in the U.S.; holding directors' meetings within the U.S.	Purchasing of materials and supplies in the U.S., as a general rule, here.[58] But, if you use purchasing agents, you should avoid clothing them with extensive discretion. Operating so that the purchase contracts will be closed and executed outside the U.S. Owning investments here, receive and distribute income therefrom and pay incidental organization expenses.[59] Affecting security transactions through a resident broker[60]—unless the broker gets his instructions from a local representative possessing managerial discretion with respect to the transactions.[61]

A business seeking tax reduction as Western Hemisphere or Possessions corporation must make sure 95 per cent or 80 per cent respectively, or its gross income does not come from sources within the United States. The following table indicates the sort of income you have to watch.

9. How You Should Conduct Your U.S. Company Relations with the Foreign Company

Dealings of any related company raise questions of fair practices. When a new company is created, it is essential to make certain that intercompany transactions

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[56] G.C.M. 21,219, 1939-1 C.B. 201.

[57] 1954 IRC § 871(c); 1939 IRC Section 211(b) includes in the meaning of the phrase, "engaged in trade or business within the United States," "the performance of personal services within the United States at any time within the taxable year." Excluded, however, is the performance of personal services by a nonresident alien individual if: (1) he is temporarily present here for no more than 90 days in the taxable year; (2) his compensation for such services does not exceed $3,000; and (3) the services are performed for a nonresident alien individual, foreign partnership, or foreign corporation.

[58] *R. J. Dorn & Co.*, 12 B.T.A. 1102 (1928).

[59] See *Scottish-American Investment Co., Ltd.*, and *Linen Thread Co., Ltd.*, *supra* note (54). Generally, any activities beyond these will be regarded by the Treasury as doing business. G.C.M. 18835, 1937-2 C.B. 141. The mere ownership of American real estate which is operated by the lessee is not doing business, *Evelyn M. L. Neil*, 46 B.T.A. 197 (1942); aliter where the owner actively manages the property, whether directly or through agents. *Von Baumbach* v. *Sargent Land Company*, 242 U.S. 503 (1917); *Pinchot* v. *Commissioner*, 113 F. (2d) 718, (C.C.A.-2, 1940).

[60] 1954 IRC § 871(c); 1939 IRC Section 211(b). Similar treatment is afforded to the effecting of commodity transactions through a resident broker if the commodities are "of a kind customarily dealt in on an organized commodity exchange."

[61] *Adda* v. *Commissioner* 171 F. (2d) 457 (C.C.A. 4-1948), cert. den., 336 U.S. 952 (1949); *Commissioner* v. *Nubar*, 185 F. (2d) 584 (C.C.A. 4-1950), cert. den. 341 U.S. (1951).

How to Compute Gross Income

Types of Income	Conditions Necessary to Gain Exemption
Interest from: Governments of the United States, any territory or political subdivision, District of Columbia,[62] any of the states or their political subdivisions.[63]	None
U.S. citizen.	If payor is not a U.S. resident.[64]
Resident alien individuals.	If 80 per cent or more of his gross income has been derived from *foreign* sources for 3 years preceding the year of payment.[65]
Domestic corporation (whether resident or not).	If 80 per cent or more of its gross income has been derived from *foreign* sources for 3 years preceding the year of payment.[66]
Foreign corporation doing business in this country.	If 80 per cent or more of its gross income has been derived from *foreign* sources for 3 years preceding the year of payment.[67]
Nonresident alien individual.	Even though all his income is from U.S.
Bank deposits in U.S.	If received by domestic or *foreign* corporations, U.S. or *foreign* citizens trusts, estates, partnerships or companies not doing business in the U.S.[68]
Domestic corporation.[69]	If payor is a Sec. 931 company; or if 80 per cent of payor's gross income came from outside U.S. for 3 years preceding the dividend.
Dividends from: Foreign corporation.[70]	If less than 50 per cent of its gross income for 3 years preceding the dividend (or for such part of the 3 years as it has been in existence) has been from U.S. sources.
Rents and royalties[71] from: Property located in U.S.	None
Permitting use in the U.S. of patents, copyright secrets, goodwill, trade marks, and similar property.[72]	None
Sale of real property located in U.S.[73]	None
Sale of personal property that has been purchased by taxpayer.	If sold outside U.S.[74]
Sale of personal property that has been manufactured in the U.S. by taxpayer.[75]	If sold outside U.S. the source is apportioned between U.S. and place of sale.
Sale of personal property that has been manufactured outside U.S. by taxpayer.	If sold outside U.S.

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[62] 1954 IRC § 861(a); 1939 IRC § 119(a)(1).

[63] *Waldorf Astoria*, 31 BTA 1009 (1935).

[64] *See* Sidney I. Roberts and William C. Warren, "Income Taxation of Non-Resident Aliens

will be approved by the Treasury Department. Relationships between the parent and its subsidiary companies or between companies owned by the same individuals are generally supervised by Section 482. It might be applied to foreign transactions in view of the unusual opportunity it provides for cutting taxes by use of one of the methods outlined. For example, an allocation may be made whether the foreign operation is conducted by a foreign or domestic corporation. In the latter case the effect may be to shatter the corporation's status under Section 931.

Under Section 482, transactions between controlled persons in any trade or business get special scrutiny. This is to find whether the control is being used to reduce, avoid, or escape taxes. This section gives the Treasury Department the authority to determine true net income.[76]

It authorizes the Treasury Department to "distribute, apportion, or allocate . . . between or among such organizations, trades, or businesses." But it does not specifically authorize the Treasury Department "to combine." Regulations[77] negate the use of this provision for the purpose of consolidating income of two or more businesses. The Section is not intended to effect an apportionment that will produce a result equivalent to the computation of consolidated net income.[78]

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and Foreign Corporations," *Current Problems in Federal Taxation,* pages 31 and 32. New York: Practicing Law Institute, 1953.

[65] 1954 IRC § 861(a)(1)(B); 1939 IRC § 119(a)(1)(B).

[66] 1954 IRC § 861(a)(1)(B); 1939 IRC § 119(a)(1)(B).

[67] 1954 IRC § 861(a)(1)(B); 1939 IRC § 119(a)(1)(B).

[68] 1954 IRC § 861(a)(1)(A); 1939 IRC § 119(a)(1)(A).

[69] 1954 IRC § 861(a)(2)(A); 1939 IRC § 119(a)(2)(A).

[70] 1954 IRC § 861(a)(2)(B); 1939 IRC § 119(a)(2)(B).

[71] 1954 IRC § 861(a)(4); 1939 IRC § 119(a)(4).

[72] Where the assignee of such rights is allowed to use them in the United States and another country, and the contract price is a single amount, the taxpayer must prove the basis of apportionment. *See Sax Rohmer,* 14 TC 1467 (1950), acquiesced 1950-2 CB 4; and *Pelham G. Wodehouse,* 15 TC 799 (1950) where apportionment was made on the basis of the respective foreign and domestic circulation figures of the assignee publishing company. Avoid the necessity for such proof; see that the assignment contract specifies separate values for the use of the right in the United States and the foreign country.

[73] 1954 IRC § 861(a)(5); 1939 IRC § 119(a)(5).

[74] 1954 IRC § 862(a)(6); 1939 IRC § 119(e). The place of sale generally governs the determination of the source of the entire proceeds. There is one exception: If the property is bought in a United States possession and then sold within the United States, there is apportionment. For method of apportionment see footnote 49, above.

[75] 1954 IRC § 863(b); 1939 IRC § 119(e).

[76] 1954 IRC § 482 (1939 IRC § 45) authorizes the Treasury Department to apportion income. It does not follow that § 482 also authorized it to distribute income allocated to corporations as dividends to stockholders. They are separate and distinct entities from the corporation. Nor does increase of the income of one company, with its resulting increases in accumulated surplus without distribution by dividends, necessarily bring the 1954 IRC § 531 (1939 § 102) tax into play. If one company owns another or there is a common ownership, the Treasury Department may reallocate income or deduction when it is essential "to prevent evasion or clearly to reflect income." But that does not apply when both companies jointly own a third. Apportionment is not possible if each of the parents holds half of the stock of the company used as an alleged source of manipulation.

[77] Reg. 118, § 39.45-1(b)(3).

[78] In controlled situations, particularly in the evasion of taxes by the shifting of profits, the making of fictitious sales and other methods frequently adopted for the purpose of "milking" profits are questioned. If the Treasury Department determines that an allocation is necessary, the company has the burden of proving that its situation is not one to which the statute applies.

Problems of intercompany relations with foreign companies are also concerned with the following points:

1. What is the effect of the control of foreign exchange in the countries involved on profits?
2. Is the payment deductible by the foreign company and is it taxable to the United States organizations?
3. What effect is there as a result of foreign tax rates, United States tax rates, and the tax credits?
4. Is the payment subject to income or excise taxes in the foreign country before it is delivered to the United States company? If it is taxed, how does that affect the foreign tax credit?
5. Does the foreign enterprise manufacture for sale as principal? Or as agent on a fee basis for a domestic company?
6. Are the foreign tax authorities likely to claim that intercompany payments are really dividends paid by the subsidiary, rather than deductible items? This may well be true of royalties.

But all these are likely to be the minor questions. Most important from the standpoint of United States and foreign taxes will be finding how to fix prices with the foreign related controlled company, and deciding on the manner of conducting the related organizations in other respects. In the consideration of both of these questions we have many cases to guide as to decisions. They seem to say that you have an arm's-length transaction (not a method of shifting profits for the purpose of evading tax), if separate books and records are kept which clearly reflect the income of the several units of a business. At issue in many difficult cases seems to be inaccurate accounting. Difficulties can be avoided if the following requirements are met:

1. The records precisely determine all income and expenses so that net income can be readily determined.
2. There is no doubt as to the legal organization and existence of the separate units as going concerns.
3. The contract between the units is reasonable. Compensation, rentals, or other payments, agreed upon by the parties must be fairly arrived at. The law seeks only to adjust and correct improper bookkeeping entries between separate businesses. It may not be used to justify arbitrary consolidation of the net income of separate companies.
4. Payments between the companies are comparable to those paid elsewhere for similar services.

This part of the law does not prevent you from transferring the use of your property to a foreign company without a charge to it, for, say, rent. The courts have

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But allocation is denied when the Treasury attempts to set up income when none exists. *Tennessee-Arkansas Gravel Co.* v. *Commissioner* (6 Cir. 1940), 112 F. 2d 508, 25 AFTR 97 reversing and remanding 37 B.T.A. 1336 (1938); *Texsun Supply Corp.* v. *Commissioner* 17 T.C. 433 (A) (1952); *Smith-Bridgman and Company* v. *Commissioner*, 16 T.C. 287 (A) (1951).

refused to allow the Treasury Department to assign to you what would have been rent income, if you rented the property. The Treasury cannot create income, it can only allocate it. But the Treasury might allocate to you some of the income from the controlled company to which you transferred the property. And you can:

1. Sell your property at a loss to a corporation if you control less than 50 per cent. The Treasury cannot disallow a deduction here, it can only allocate, distribute, or apportion it.
2. Get property from a controlled company tax free upon liquidation and then sell it.
3. Organize a corporation, partnership, or sole proprietorship to do some of the business done before by the controlled business. Here you must have a natural division of the business functions such as—one entity manufactures, the other sells and distributes; one operates the property, the other owns it; one trades for its own account, the other acts as broker.

In the split off from the corporation it makes no difference that the corporation could have done all the new business it is doing; the split off may not have been in the "best corporate interest."

But you may not organize another entity not doing anything to produce its income; say, a corporation turning over to a stockholder partnership all the receipts less a profit of 10 per cent—with the partnership doing nothing. Neither may you set up separate management-subsidiary corporations and treat their income as yours, nor buy from an affiliate far above or below market and then sell at a loss or gain—say, sell below cost to an affiliate outside U.S. which sells at a gain.

You can have effective, independent operation in good faith between the controlled parties. Be sure that separate identity is definite. Even with overlapping management be ready to show business decisions are reached independently.

Set prices between controlled groups exactly as they would be for any outsider. You may have prices favoring the controlled unit if—

1. Price charged is fair as compared to others.
2. Price is reduced, as it would be for outsiders, only because of reduced credit risks; greater volume of business; less chance of returns or allowances.
3. Price covers all overhead and cost production of the controlled unit.
4. Price is not varied because of profits by one company or the other.
5. Price in selling unit is based upon a fair distribution of overhead between the units. Changing the mechanics of overhead distribution is symptomatic of diverting profits.
6. Year-end adjustments are avoided—the sales price once fixed is consistently applied except for adjustments similar to those made for outsiders.

How can you avoid the risk of Treasury reallocation of family interests? First you can arrange not to have controlled persons. That may come by:

1. Having independent stockholders who own two isolated companies owning equally the stock of a third company.
2. Buying or selling cooperatives owned by unrelated groups. Advantages here

are: Corporation need pay no taxes if it can distribute all its earnings to stockholders; distribution need not be in cash; cooperatives may create considerable working funds by distributions in scrip, stock, notes, etc. When owned by a group of corporations, the corporations can deal with each other so that profits earned in a joint venture may be split on the basis of sale without a tax to the cooperative; rebates on purchases from central source dealing for the group is readily arranged. When used as a common subsidiary, the cooperative avoids many difficulties encountered when there is a parent-subsidiary or another related company arrangement.

10. How to Set Up These Companies

When creating a new corporation for use in foreign trade, you must consider Section 269. It prohibits acquisitions of corporations or corporate property for the principal purpose of: evading or avoiding taxes; securing the benefit of a deduction, credit, or other allowance that would not otherwise be enjoyed.

The purpose of the section is to prevent a company from reducing income tax liability by distorting various sections of the tax law. That might include the use of operating loss carry-overs, reductions, credits, or allowances to which a company would not be entitled in the normal conduct of its business.

Basically, Section 269 reaches two types of corporate transactions:

1. Acquisitions, direct or indirect, of control of a corporation by any person or persons.
2. Acquisitions, direct or indirect, by any corporation of property of another corporation, when the basis of the property in the hands of the acquiring corporation is determined by reference to the basis in the hands of the transferor corporation; and when the acquiring corporation or its stockholders did not control the transferor corporation directly or indirectly immediately prior to the acquisition.

If the acquiring corporation did not control the transferor corporation previously and if the principal purpose of the transfer is the evasion or avoidance of taxes, a disallowance of the assumed benefits of the transfer may follow. This is done by denying the benefit of a deduction, credit, or other allowance that the acquiring person or corporation would otherwise enjoy.

Fortunately, the Internal Revenue Service has conceded[79] that the formation of a Western Hemisphere company does not run afoul of the law. The ruling appears to apply with equal emphasis to the companies created under Section 931.

With the creation of a Foreign corporation, it may be necessary to determine whether the new company comes within the condemned process.[80] The conditions of foreign operation today would seem to negate that requirement. In an

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[79] I.T. 3737, 1945 C.B. 200.

[80] "Principal purpose" is a question of fact. You have a negative burden of proof in this case. You must be able to prove that the "principal purpose" of the acquisition in question was not evasion or avoidance. If the purpose to evade or avoid tax exceeds in importance any other purpose, it is the principal purpose. Some rules may be suggested:

1. The test must be a subjective one to determine the factor which was most important in causing the acquisition. It is not difficult to imagine cases involving numerous motivating factors. Then you must establish what can properly be regarded as the "principal reason."
2. You will probably have to show that the aquisition of the new company would not have

era of distorted currencies, a defense of business needs would seem simple.

11. Credit for Taxes of Foreign Countries

Obviously if you did business in a foreign country and paid an income tax both there and here, your profits would be seriously curtailed.

To eliminate the burden of this double taxation a credit is granted for income and profits taxes paid to a foreign country. If you are a United States citizen or a domestic corporation, you may elect to deduct the foreign taxes or to use them as a credit against United States taxes.[81]

One method may result in a lower tax liability than the other, depending upon the rules. You may make a new election each year. And you may even change the election for the same year if you later discover it is to your advantage to do so. But that must be done within the time that you are allowed to make a claim for refund for that year.[82] You cannot take a part credit and part deduction in one year. You must treat all foreign taxes paid as all credit or all deduction.

Citizens, domestic corporations, resident aliens, partnerships, and estates all can claim the credit or deduction. But the rules for each may vary.

Citizens and domestic corporations get the credit or deduction for taxes paid to foreign countries or U.S. possessions.[83]

Resident aliens get the credit or deduction for taxes paid to U.S. possessions. But they get the credit or deduction for taxes paid to a foreign country only if the country of their citizenship allows a similar credit to U.S. citizens.[84] The credit or deduction is determined by the policy of the country of their citizenship, not that of the country to which the tax is paid. In a recent case[85] a Belgian citizen (U.S. resident alien) paid Canadian taxes. He did not get a credit against U.S. taxes because Belgium did not allow a similar credit. Canada did allow the credit.

The election applies to your proportionate share of foreign and U.S. possessions taxes paid by a partnership, trust, or estate.[86]

The credit is allowed only for income, war profits, excess profits taxes, and similar taxes in the nature of an income tax.[87] It does not apply to any taxes paid to

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been made except for the stated business reason, and that the tax advantage was considered only to the degree that any prudent businessman would deem wise.

3. It is not necessarily sufficient to prove the converse, namely that the acquisition would have been made even if the tax-reducing factor was not present. In this case, the tax reason could still be the principal one. In the preceding paragraph the business reason is clearly most important.

4. The "principal purpose" may be a "business purpose," although the choice of aquisition is motivated primarily by tax avoidance.

[81] 1954 IRC §§ 901(a) and 903; 1939 IRC § 131(a) and (h).

[82] Reg. 118, § 39.131(a)-1.

[83] 1954 IRC § 901(b)(1); 1939 IRC § 131(a)(1).

[84] 1954 IRC § 901(b)(3); 1939 IRC § 131(a)(3).

[85] *Freudmann*, 10 T.C. 775 (1948).

[86] 1954 IRC § 901(b)(4); 1939 IRC § 131(a)(4).

[87] *Santa Eulalia Mining Co.*, 2 T.C. 241 (1943) petition for review dismissed (9 Cir. 1944), 142 F. 2d 450, 32 AFTR 673; *Seatrain Lines, Inc.*, 46 B.T.A. 1076 (1942), petition for review dismissed (5 Cir. Nov. 16, 1942); *Keasbey & Mattison Co.* v. *Rothensies* (3 Cir. 1943), 133 F. 2d 894, 30 AFTR 990, cert. den. 320 U.S. 739 (1943); *Helvering* v. *Campbell* (4 Cir. 1944), 139 F. 2d 865, 31 AFTR 1228; *New York and Honduras Rosario Mining Co.*, 8 T.C. 1232 (1947).

foreign countries on sales, gross receipts, production, the privilege of doing business, personal property, or export of capital. It may include:

1. A tax like one of our own taxes on income.
2. A tax paid in lieu of taxes that would otherwise be imposed by any foreign country or by any possession of the United States upon income, war profits, and excess profits.
3. A tax of a foreign country imposed upon income, when for reasons growing out of administrative difficulties in determining net income or basis within that country, the tax is measured by gross income, sales, and number of units produced.

The credit is intended to apply only to the regular impositions made for the purpose of raising public revenue by foreign governments upon persons, property, privileges, occupations, and enjoyments of the people subject to such taxation. It does not apply to legislative enactments to compel enforced contribution for the purpose of regulating business or industry. The credit does not apply to reduce[88] the surtax on undistributed profits or the personal holding company taxes.

If the foreign country's rates are less than our rates, the United States taxes the foreign income on the difference. But if the rates in the foreign country are higher than here, then the United States does not tax the foreign income.

To get the credit for a foreign tax, you must be directly subject to that tax.[89] This means not only that you or your corporation must pay the tax but that the tax is levied directly upon you. To find your credit, use this rule:[90] Your credit cannot be more than that part of your U.S. tax that is determined by the ratio of your foreign taxable income to your total taxable income.[91]

Here is an example to show how that works: A domestic corporation has income from within a foreign country of $25,000. It paid a foreign income tax of $12,000. Its total income of $75,000 is subject to a U.S. tax of $29,750. The credit is limited to ⅓ ($25,000/$75,000) of $29,750 or $9,916.67.

If a corporation has income from two or more foreign countries, its tax credit is subject to two limitations. First, the credit for each country is limited. Second, the sum of the adjusted credits is limited. The maximum allowed is fixed by the proportion which total foreign taxable income bears to total taxable income.[92]

If a domestic company owns 10 per cent or more of the voting stock of a Foreign company and receives dividends from it, the credit is based upon the proportion of taxes paid to the foreign country, in the ratio of the amount of dividends to the amount of the profit.[93] The same privilege is given when the Foreign company owns 50 per cent or more of the voting stock of another Foreign corporation from which it receives dividends.[94] Consideration is given to the foreign income tax paid by the second corporation.[95] This rule is not used when the domestic company owns less than 10 per cent of the voting stock of a Foreign company.

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[88] Reg. 118, § 39.131(h)-1.

[89] There is one exception. 1954 IRC § 902(a) (1939 IRC § 131(f)) covers the situation of a domestic corporation owning at least 10 per cent of the voting stock of a Foreign company.

[90] 1954 IRC § 904; 1939 IRC § 131(b).

[91] 1954 IRC § 904(a); 1939 IRC § 131(b)(1). *See Burk Bros.*, 20 B.T.A. 657 (1930); *Briskey Co.* 29 B.T.A. 987, affirmed (3 Cir. 1935) 78 F. 2d 816, 16 AFTR 490.

[92] Reg. 118, § 39.131(b)-1 gives extensive examples of how the Treasury Department expects this formula to be used. See also G.C.M. 16144, XV-1 C.B. 152 (1936); G.C.M. 21432, 1939-2 C.B. 234. Net income may include partially taxed capital gains, but not income untaxed in the U.S. even if taxed abroad. Dividends from foreign corporations are derived from sources abroad.

[93] 1954 IRC § 902(a); 1939 IRC § 131(f)(1) as amended by § 332 of the Revenue Act of 1951.

Regardless of the method of accounting used, the credit for foreign taxes may be taken in the year of payment or when the tax accrues. If the credit is taken in the year of accrual, it must be similarly taken in all later years.

Foreign exchange restrictions may sometimes cause the income not to be included by the domestic company for a specific year. Then the credit is taken proportionately as the foreign income becomes includable.[96]

In figuring the credit, the foreign taxes paid must be computed in United States dollars. Foreign currency may be changed to United States dollars in the following way:

In the Case of	Use Rate of Exchange in Effect
Cash-basis accounting	On the date of payment of the foreign tax
Accrual-basis accounting	On the last day of the taxed year[97]
Parent-subsidiary relationship	On the date upon which the dividend was declared by the foreign subsidiary, not when the foreign taxes were paid.[98]

12. Tax Treaties Are Important

If you do business with Australia, Argentina, Canada, Sweden, France, the United Kingdom, Belgium, Denmark, Finland, Germany, Greece, Ireland, Japan, the Netherlands, New Zealand, Norway, Switzerland, or the Union of South Africa, this section is important. As of June, 1955, the United States had treaties and agreements with these countries in order to limit the double taxation of income.[99]

Each of the treaties provides that an American business enterprise is not to be taxed on its business profits in the foreign country unless it maintains a permanent establishment in the foreign country.[100] When there is a permanent establishment, the treaties provide for the method of allocating profits. In no case does the mere purchase of goods result in a tax in the foreign country.

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[94] 1954 IRC § 902(b); 1939 IRC § 131(f)(2) as amended by § 332(b) of the Revenue Act of 1951.

[95] Reg. 118, § 39.131(f)-1.

[96] Reg. 118, § 39.131(d)-1.

[97] I.T. 1645, II-1 C.B. 141 (1923).

[98] *The Bon Ami Co.*, 39 B.T.A. 825 (1939).

[99] Those doing business with the countries listed below should also check as to treaty developments. As of June, 1955, the United States was negotiating tax treaties with the following countries: Austria, Brazil, Colombia, Cuba, Honduras, India, Israel, Italy, Luxembourg, Mexico, Paraguay, the Philippines, and Uruguay.

[100] Canada—§ 7.23 (T.D. 5306); Sweden—§ 25.3 (T.D. 4975); France—§ 7.414 (T.D. 5499); United Kingdom—§ 7.516 (T.D. 5569); Article III of each of the tax conventions entered into with Australia, Belgium, Denmark, Germany, Greece, Ireland, the Netherlands, New Zealand and Norway; Article V of the tax convention entered into with the Union of South Africa.

The term "permanent business" becomes of importance.[101] It undoubtedly means the maintenance of an office at which you buy or sell, a factory, or some other comparable branch. A subsidiary corporation is not necessarily a "permanent establishment" of its parent. Certainly there is freedom from tax if (1) you have a foreign agency, unless your agent can and does make contracts or has your merchandise in store and regularly fills your orders; (2) you carry on business in the foreign country through a public commission agent, broker, or custodian; (3) you have an office in the foreign country only for the purpose of buying goods.

In addition to the exemption on business profits, the treaties prevent double taxation of specific sources of income for our companies trading abroad. Consult the table on pages 141-144 for the method of taxing different types of income in the various foreign countries.

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[101] Canada—§ 7.22 (T.D. 5206); Sweden—§ 25.2 (T.D. 4975); France—§ 7.413 (T.D. 5499); United Kingdom—§ 7.515 (T.D. 5569(a)); and the following sections of the tax conventions with the following countries: Belgium, Article II(f); Denmark, Article II(c); Greece, Article II(i); Ireland, Article II(l); Netherlands, Article II(i); New Zealand, Article II(o); Norway, Article II(c); Union of South Africa, Article II(d); Finland, Article II; Australia, Article II; Germany, Article II; and Japan, Article II.

TAXES DUE UNDER TREATIES

If Your Income Is From	And the Foreign Country Is	Then You Are Taxed Only by the Country of
Operation of ships or planes[102]	Australia	Registration
	Belgium	Registration
	France	Registration
	Germany	Registration
	United Kingdom	Registration
	Canada	Registration
	Sweden	Registration
	Denmark	Registration
	Netherlands	Registration
	Greece	Registration
	Ireland	Registration
	New Zealand	Residence
	Norway	Residence
	Finland	Registration
	Switzerland	Registration
Royalties from intangible assets[103]	Australia	Residence[104]
	Germany	Residence[104]
	Belgium	Residence[104]
	France	Residence[104]
	United Kingdom	Residence[104]
	Sweden	Residence
	Denmark	Residence[104]
	Greece	Residence[104]
	Ireland	Residence[104]
	Netherlands	Residence[104]
	New Zealand	Election[107,108]
	Norway	Residence[104]
	Canada	Residence[104]
	Finland	Residence[104]
	Switzerland	Residence[104]

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[102] Canada—§ 7.26 (T.D. 5206); France—§ 7.416 (T.D. 5499); Sweden—§ 25.5 (T.D. 4975); United Kingdom—§ 7.518 (T.D. 5569); and the following sections of the conventions with the following countries: Belgium, Article VII (1); Denmark, Article V; Netherlands, Article VI; Greece, Article V; Ireland, Article V; New Zealand, Article V; Norway, Article V; Finland, Article V; Australia, Article V; South Africa, Prot. I; Germany, Article V.

[103] France—§ 7.418 (T.D. 5499); Sweden—§ 25.8 (T.D. 4975); United Kingdom—§ 7.519 (T.D. 5569); and the following sections of the conventions with the following countries: Belgium, Article IX(2); Denmark, Article VIII; Greece, Article VII; Ireland, Article VIII; Netherlands, Article IX; New Zealand, Articles VII, VIII; Norway, Article VII; Canada, Article XIII(C); Australia, Article X; Germany, Article VII; and Finland, Article VIII.

[104] Unless you have a permanent place of business in the country of payment.

[105] Dividends and interest paid by a United States corporation, not managed and controlled in Canada to a resident of the United States or to a corporation not managed and controlled in Canada, is exempt from Canadian taxes.

[106] Interest paid by a Canadian corporation to Canadian residents (not U.S. citizens) or Canadian corporations are exempt from U.S. tax.

[107] Under certain conditions, you may elect to be taxed by the paying country on a net basis. You are taxed as if you were engaged in business in the paying state through a permanent establishment.

[108] Motion picture rental is taxed in the country of residence, subject to the limitations of footnote 104 above.

Taxes Due Under Treaties (Continued)

If Your Income Is From	And the Foreign Country Is	Then You Are Taxed Only by the Country of
Profit on sale of capital assets[109]	Norway	Property[109]
	France	Residence[104]
	Canada	Residence[104]
	Sweden	Residence[104]
Rents, and royalties from mines or other natural resources[110]	Australia	Election[107]
	Belgium	Property[107]
	France	Property[107]
	United Kingdom	Residence[112]
	Sweden	Property
	Denmark	Property[107]
	Greece	Election[107]
	Ireland	Property[111]
	Netherlands	Election[107]
	New Zealand	Property[107]
	Norway	Election[107]
	Finland	Election[107]
	Switzerland	Election[107]
	Germany	Election[107]
	South Africa	Election[107]
Interest[113]	United Kingdom	Residence[104,115]
	Sweden	Residence[114]
	Denmark	Residence[104]
	Greece	Residence[104,115]
	Ireland	Residence[104,115]
	Netherlands	Residence[104,115]

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[109] Canada—§ 7.29 (T.D. 5206); France—§ 7.421 (T.D. 5499); Sweden—§ 25.10 (T.D. 4975); Norway, Article IX. Similar proposals were contained in the conventions with Denmark, Article XII, the Netherlands, Article XI, and Ireland, Article XIV, but were rejected by the U.S., when the conventions were ratified.

[110] France—§ 7.417 (T.D. 5499); Sweden—§ 25.7 (T.D. 4975); United Kingdom—§ 7.519 (T.D. 5569); and the following sections of the conventions with the following countries: Belgium, Article IX; Denmark, Article IX; Greece, Article VIII; the Netherlands, Articles V, X; New Zealand, Article VII; Norway, Article VIII; Finland, Article IX; Switzerland, Article IX; Australia, Article XI; Germany, Article IX; South Africa, Prot. III.

[111] U.S. residents, subject to U.S. tax and not in trade or business in Ireland, are exempt from Irish tax. Irish residents, subject to Irish tax and not in trade or business in U.S., are not to pay more than 15 per cent U.S. tax. But an Irish resident can elect to be taxed in U.S. as if he were engaged in trade or business here. Convention with Ireland, Article IX.

[112] U.S. may tax residents of this country up to 15 per cent on this income from U.S. sources. U.S. residents who have the same income from this country's sources are not subject to tax.

[113] Sweden—§ 25.9 (T.D. 4975); United Kingdom—§ 7.519 (T.D. 5569); and the following sections of the conventions with the following countries: Denmark, Article VII; Greece, Article VI; Ireland, Article VII; the Netherlands, Article VIII; Norway, Article VI; Belgium, Article VIIIA; Canada—§7.32 (T.D. 5206); Finland, Article VII; Germany, Article VII; Switzerland, Article VII.

[114] Sweden and the U.S. have the right to deduct at the source taxes not in excess of 10 per cent of the dividend while they may deduct at the source taxes on interest without any percentage limitation.

[115] But interest (except mortgage interest) paid by a subsidiary organized in one country to a parent (owning more than 50 per cent of the subsidiary's stock) is not exempt in either country. The Greek and Irish treaties do not except mortgage interest and, in the case of interest from Greek sources applies only to interest not in excess of 9 per cent.

Taxes Due Under Treaties (Continued)

If Your Income Is From	And the Foreign County Is	Then You Are Taxed Only by the Country of
	Norway	Residence[104]
	Canada	Note[105,106]
	Finland	Residence[104]
	Belgium	Note[119]
	Germany	Residence[104]
	Switzerland	Note[121]
Dividends[116]	United Kingdom	Residence[104,112,117]
	Canada	Note[105,117]
	Sweden	Residence[114]
	Denmark	Residence[118]
	Netherlands	Residence[104,112,117]
	New Zealand	Residence[112,117]
	South Africa	Note[117]
	Greece	Note[117]
	Belgium	Note[120,112]
	Ireland	Note[122]
	Australia	Note[123]
	Germany	Note[124,117]
	Finland	Note[124]

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[116] Canada—§ 7.32 (T.D. 5206); Sweden—§ 25.9 (T.D. 4975); United Kingdom—§ 7.519 (T.D. 5569); and the following sections of the conventions with the following countries: Belgium, Article VIII; Denmark, Article VI; Netherlands, Article VII; New Zealand, Articles VI, XII; Greece, Article IX; Ireland, Article VI; Australia, Article VII; Germany, Articles VI, XIV; Finland, Article VI.

[117] Dividends paid by a corporation of the foreign country to residents (not U.S. citizens), or corporations of the same country are exempt from U.S. tax.

[118] U.S. and Denmark have the right to deduct at source taxes which may not exceed 15 per cent if there is no permanent establishment in the country of payment.

[119] U.S. and Belgium reciprocally reduce the rate of tax on interest from any form of indebtedness from sources within one country by a resident or other entity of the other country not having a permanent establishment in the taxing country to 15 per cent.

[120] Dividends derived from sources in Belgium are exempt from the personal complementary tax or surtax or any tax similar to the U.S. withholding tax in case of nonresident aliens or foreign corporations.

[121] U.S. and Switzerland reduce the tax rate on interest income to 5 per cent, including mortgages or bonds secured by real property provided there is no permanent establishment in the country of payment. The reduced rate is not applicable to Swiss taxes on interest from Swiss sources on a Swiss citizen who is a resident of the United States.

[122] The provisions as to dividends paid by a U.S. subsidiary corporation to an Irish parent corporation are similar to the provisions in the Belgian treaty. (*See* footnote 116, above.) In addition, the treaty with Ireland puts a 15 per cent maximum U.S. tax on dividends paid to Irish residents and exempts from Irish tax dividends received by U.S. residents.

[123] U.S. and Australia may reciprocally tax each other's residents up to 15 per cent on this income.

[124] The provisions as to dividends are similar to the provisions of the Belgian treaty.

The taxes exempted under treaties with these foreign countries are:

Country	Taxes Covered
Belgium[125]	Income taxes, national crisis tax, personal complementary tax
Canada[126]	Dominion income taxes including surtaxes; excess profits tax
Denmark[127]	National income tax, including the war profits tax; intercommunal income tax; communal income tax
France[128]	Real estate, industrial and commercial profits, undistributed profits—annual; agricultural profits; salaries, allowances, emoluments, wages, pensions, and annuities; professional profits; securities and movable capital income; general income
Greece[129]	Income tax, including the schedular or analytical tax, the complementary tax, and the professional or business tax
Ireland[130]	The income tax and surtax and the corporation profits tax
Netherlands[131]	Income tax, corporation tax, property tax, tax on fees of directors and managers of corporations, capital accretions tax, extraordinary capital tax
New Zealand[132]	Income tax, and social security charge
Norway[133]	National and communal income taxes, old age pension tax, war pension tax, bank deposits tax, seamen's tax
Sweden[134]	National income and property, including surtaxes; national special property; communal income
Union of South Africa[135]	Normal and super taxes, undistributed profits tax, nonresident shareholders' tax, excess profits duty, trade profits special levy
United Kingdom[136]	Income, including surtaxes; excess profits; National Defense contribution
Finland[137]	State (National) income tax[119]
Switzerland[138]	Federal cantonal, and communal taxes on income
Australia[139]	Commonwealth income tax, and social services contribution
Germany[140]	Income tax, corporation tax, and the Berlin emergency contribution

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[125] Article I, Convention between the U.S. and Belgium.
[126] Item I, Protocol to Convention between U.S. and Canada.
[127] Article I, Convention between U.S. and Denmark.
[128] Article I, Convention between U.S. and France.
[129] Article I, Convention between U.S. and Greece.
[130] Article I, Convention between U.S. and Ireland.
[131] Article I, Convention between U.S. and Netherlands.
[132] Article I, Convention between U.S. and New Zealand.
[133] Article I, Convention between U.S. and Norway.
[134] Article I, Convention between U.S. and Sweden.
[135] Article I, Convention between U.S. and Union of South Africa.
[136] Article I, Convention between U.S. and United Kingdom.
[137] Article I, Convention between U.S. and Finland.
[138] Article I, Convention between U.S. and Switzerland.
[139] Article I, Convention between U.S. and Australia.
[140] Article I, Convention between U.S. and Germany.

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7. C.495.M.147.1928.II. Summary of the Observations Received by August 30, 1928, from the Government on the Report Submitted by the Committee of Technical Experts on Double Taxation and Tax Evasion.
8. C.415.M.171.1931. II.A. Fiscal Committee, Report to the Council on the Work of the Third Session of the Committee.

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8

Western Hemisphere Corporations

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The inequality of tax burdens has been a principal problem of the United States corporation competing with foreign companies in international trade. Although many foreign companies are directly or indirectly subsidized, the United States corporation for many years has paid full corporate taxes on its foreign income.[1]

This substantial tax deterrent became a cause for governmental concern when the effect was to discourage the extension of United States trade within the bordering Western Hemisphere countries. Although the need for such trade has been long recognized as a necessary adjunct to the diplomatic integration of these countries, our government's fiscal branch has been slow to observe or admit the significance of the tax impact as a major obstacle.

The statutory conception of the Western Hemisphere trade corporation, with its preferential tax rates, represents the best efforts thus far to remove the tax obstacle and to provide a tax inducement for increasing United States trade within the Western Hemisphere.

1. Points to Consider

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[1] *Barclay & Co.* v. *Edwards*, 267 U.S. 442, 451, 5 AFTR 5153 (1924). "The injustice thought to be worked upon domestic corporations engaged in sales abroad, by a different classification, for purposes of taxation, of foreign corporations similarly engaged, is an argument, not for the constitutional invalidity of the law before a court, but for its repeal before Congress."

2. Initial Legislation

In 1939, "for the purpose of stimulating American trade abroad,"[2] Congress extended the pitifully small benefit of the Pan American trade corporation: a domestic subsidiary doing business in Central and South America, and its domestic parent corporation, were privileged to file consolidated returns so that the losses of one could reduce the profits of the other.[3] But it was the impact of higher taxes during World War II that demonstrated the need for more substantial relief, and in its report in 1942 the Senate Finance Committee said:

> American corporations trading in foreign countries within the Western Hemisphere are placed at a considerable competitive disadvantage with foreign corporations under the tax rates provided by this bill. To alleviate this competitive inequality, the committee bill relieves such corporations from surtax liability.[4]

The result was the addition of Section 109 to the 1939 Internal Revenue Code, providing that a domestic corporation which met the tests of a Western Hemisphere trade corporation was exempt from both the surtax and the World War II excess profits tax. This provision now appears as Section 921 of the 1954 Internal Revenue Code.

3. Basic Tax Advantages

The absence of an excess profits tax from 1946 through 1949 made the Western Hemisphere corporation less significant from a tax standpoint, but the reinstatement of that tax in 1950 again awakened a widespread interest in the substantial tax benefits afforded by such a corporation. Prior to January 1, 1954, these benefits were, first, the reduction of normal tax net income by a credit of 28 per cent for 1951 and 27 per cent thereafter;[5] and, second, a full exemption from excess profits tax.[6] From and after January 1, 1954, the absence of the excess profits tax is a benefit to all corporations; hence, no longer is its absence a special benefit of the Western Hemisphere corporation. But the 27 per cent *credit* has been continued "in effect" by the "Sec. 922 Special Deduction" which is computed in accordance with new simplified statutory language as follows:

> (1) First determine the taxable income of such corporation computed without regard to this section.
> (2) Then multiply the amount determined under paragraph (1) by the fraction—
>   (A) the numerator of which is 14 per cent, and
>   (B) the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

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[2] Sen. Rep. No. 648, 76th Cong. 1st Sess. 9 (1939).

[3] 1939 IRC § 152, now repealed by § 159(b), 1942 Rev. Act.

[4] Sen. Rep. No. 1631, 77th Cong. 2d Sess. 32 (1942).

[5] 1939 IRC § 26(i). The complete exemption from surtax was eliminated in 1950 when Section 122(c) of the Revenue Act of 1950 substituted in lieu thereof a credit against normal tax net income of 33 per cent for 1950 and 30 per cent thereafter.

[6] 1939 IRC § 454(f). This section provided an excess profits tax exemption to *any* domestic corporation whose gross income is 95 per cent derived from outside the United States and 50 per cent from the active conduct of a business. The Western Hemisphere trade corporation requirements are more strict; hence automatically fall within Section 454(f).

Under Section 11 the normal tax and surtax rates total 52 per cent; divide that figure into 14 per cent and the result is 26.923 per cent—the substantial equivalent of the 27 per cent credit allowed prior to the 1954 Code.

Translating these tax benefits into monetary terms, under the old Section 109 a corporation having Western Hemisphere annual income of $250,000 would have paid total Federal taxes of $89,400 (35.76 per cent) in 1953 if it qualified as a Western Hemisphere trade corporation but, if it did not so qualify, it would have paid maximum Federal taxes (including excess profits taxes) of $169,500 (67.8 per cent) in 1953. Eliminating the excess profits tax which expired on December 31, 1953, nonqualification under the present Section 921 would result in a 1954 Federal tax burden of $124,000 (49.6 per cent) as compared with taxes of $89,500 if the Western Hemisphere trade requirements are met.

It is a pleasant surprise that this is one situation where Congress has not, by other taxing or disallowance provisions, sought to recapture the tax saving. The foreign tax credit[7] is fully available to the Western Hemisphere corporation; the tax savings may be passed into a parent organization with the further benefit of the 85 per cent-dividend received credit,[8] or this may even be accomplished by a tax-free liquidation so long as the parent owns at least 80 per cent of its stock.[9] Even the Treasury Department has caught some of the spirit behind this hemispheric tax subsidization, for it has ruled that the income credit and excess profits tax exemption will not be disallowed under Section 269 (1939 Code Section 129) although the Western Hemisphere corporation was expressly formed or acquired for the purpose of minimizing taxes.[10]

Additional advantages are that a Western Hemisphere corporation may be excluded from an affiliated corporate group filing a consolidated return; or, if included in the consolidated return, the Western Hemisphere corporation income is exempt from the additional 2 per cent tax imposed as the price for a consolidated return.[11] Moreover, the dividends of a Western Hemisphere corporation will qualify under Section 861(a)(2)(A) (1939 Code Section 119(a)(2)(A)) as having their source outside the United States and, therefore, will be entirely free from tax if received by a foreign corporation or by a nonresident alien not engaged in business in the United States.[12]

4. Disadvantages

The numerous tax advantages are obtained only at the price of a few substantial disadvantages in adopting the Western Hemisphere corporate pattern. Thus, if such a corporation is created as a subsidiary it is evident that during an excess profits tax era the parent corporation will lose a part of its excess profits credit. The Western Hemisphere corporation is subject to the Section 531 (1939

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[7] 1954 IRC § 901; 1939 IRC § 131.

[8] 1954 IRC § 243; 1939 IRC § 26(b).

[9] 1954 IRC § 332; 1939 IRC § 112(b)(6).

[10] I.T. 3757, 1945 C.B. 200. 1954 IRC § 269; 1939 IRC § 129 disallows a corporate "deduction, credit or other allowance" where the source corporation is acquired principally to avoid Federal income or excess profits tax.

[11] 1954 IRC § 1503; 1939 IRC § 141(c).

[12] 1954 IRC §§ 882(b), 871(a)(1); 1939 IRC §§ 231(c), 211(a)(1).

Code Section 102) surtax on unreasonably accumulated surplus and it is also subject to the personal holding company surtax.[13] Moreover, if the pattern is that of a controlling corporation making a first sale to its affiliated Western Hemisphere corporation, which thereafter will make a second sale to the final purchaser, the Bureau may use Section 482 (1939 Code Section 45) to enforce an arm's-length price in the first sale and thus reduce the low-taxed profit on the second sale made by the Western Hemisphere corporation.[14]

But perhaps the greatest disadvantages are the changes in sales practices which are usually necessary in order to qualify as a Western Hemisphere corporation, and the danger that the new sales practices might subject the corporation to foreign taxes because of "doing business" in the foreign country. These sales practices must be adopted with the inflexible purpose of meeting the qualifying requirements of Section 921.

5. Statutory Requirements

The principal requirements of Section 921 are that—as to *source* of income—all of the business (other than incidental purchases)[15] must be from within the Western Hemisphere,[16] and that at least 95 per cent of the gross income must be from sources outside the United States; and—as to *type* of income—at least 90 per cent of gross income must be from the "active conduct of a trade or business."[17]

a. "Active Business" requirement. The "active business" requirement is without exact precedent in the tax laws. One court has truthfully said that "The words 'trade or business' have many shades of meaning" and that "Definitions, taken from other cases dealing with other situations and in other settings, are of little help."[18] Of even less help is the Commissioner's regulation which merely repeats the words of the statute.[19] With only a 10 per cent nonbusiness income leeway, a strict statutory construction could easily destroy the Western Hemisphere tax status. Hence, it is important to exclude from income of the Western Hemisphere corporation such items as dividends, interest, and royalties derived from licensing arrangements.

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[13] 1954 IRC §§ 541-547; 1939 IRC §§ 500-511.

[14] 1954 IRC § 482; 1939 IRC § 45 authorizes the Commissioner to allocate items of income and deduction as between related organizations if "necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations . . ." Rev. Rul. 15, 1953-1 C.B. 141 holds that Section 45 will be applied in a proper case to transactions between parent corporation and its Western Hemisphere subsidiary corporation.

[15] 1939 IRC § 109 referred to a Western Hemisphere corporation as one "all of whose business is done in any country . . ." within the Western Hemisphere. 1954 IRC § 921 inserted the parenthetical phrase: "all of whose business (other than incidental purchases) is done in any country. . . ." This amendment eliminates the danger of disqualification because the corporation has purchased some component outside the Western Hemisphere for the product sold within that limited area.

[16] Defined in § 921 as "North, Central, or South America, or in the West Indies." Included is Puerto Rico, I.T. 3748, 1945 C.B. 152, and the Virgin Islands; I.T. 4067, 1951-2 C.B. 55. Bermuda is not included. I.T. 3990, 1950-1 C.B. 57. Section 109 of the 1939 Code expressly included Newfoundland within the Western Hemisphere orbit; but, the reference to Newfoundland was dropped from Section 921 of the 1954 Code because the island has qualified as a province of Canada since March 31, 1949.

[17] These gross income requirements must be met "for the three-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence)."

[18] *Hughes* v. *Commissioner* (10 Cir. 1930), 38 F. 2d 755, 759, 8 AFTR 10385.

[19] Reg. 118, § 39.109-1.

b. 95 per cent of gross income requirement. But there is even less room for error in the more significant requirement that 95 per cent of gross income must be "derived from sources other than sources within the United States." [20] Since the income from property produced within the United States and sold outside is apportioned between the two sources,[21] it is evident that a corporation engaged in manufacturing in the United States normally could not qualify as a Western Hemisphere corporation. Such a corporation must restrict its United States activities to the purchase of goods, followed by a sale which takes place within the Western Hemisphere but outside the United States; and the principles of Sections 861 and 862 establish the rule that the "income source" is at the place of sale:

> Income derived from the purchase and sale of personal property shall be treated as derived *entirely* from the country *in which sold* . . . The 'country in which sold' ordinarily means the place where the property is marketed.[22]

Thus, the chief problem of the Western Hemisphere corporation is colored by both legal and business questions: (1) legally, when does the sale occur outside the United States; (2) from the business standpoint, is it possible to rearrange existing sales transactions to meet the legal requirements?

6. Income "Source" is at the Place Where Title Passes

The Treasury Department has been less than firm in its view of the legal rules which determine the place of sale. After following for many years the rule that the place where title passes determines the source of income,[23] in 1930 the Treasury Department shifted to the rule that the place of execution of the contract of sale is determinative.[24] But in 1947 G.C.M. 25131 made the place of passage of beneficial title the determinative factor:

> . . . for the purpose of determining the source of income attributable to the sale of personal property; a sale is consummated at the place where the seller surrenders all his right, title and interest to the buyer. In cases where the bare legal title is retained by the seller, the sale will be deemed to have occurred at the time and place of the passage to the buyer of the beneficial ownership and risk of loss.[25]

But just in case taxpayers should take the Treasury Department at its literal word, the ruling continues:

> However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not apply . . . In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and

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[20] 1954 IRC § 921(1); 1939 IRC § 109(a).

[21] Reg. 118, § 39.119(e)-1.

[22] Reg. 118, § 39.119(a)-6.

[23] G.C.M. 2467, VII-2 C.B. 188.

[24] G.C.M. 8594, IX-2 C.B. 354.

[25] G.C.M. 25131, 1947-2 C.B. 85. This ruling followed the Commissioner's acquiescence in *East Coast Oil Company*, 31 B.T.A. 558 (1934), aff'd (5 Cir. 1936) 85 F. 2d 322, 18 AFTR 446, cert. den. 299 U.S. 608 (1936), Ac. 1947-2 C.B. 2.

the sale will be treated as having been consummated at the place where the substance of the sale occurred.

The last quotation, while applicable to foreign income generally, would not appear applicable to a Western Hemisphere corporation which obviously is formed with "the principal purpose of tax avoidance." It is manifest that Congress created this tax fiction as an invitation and inducement to tax minimization, and the Treasury Department has held that its "principal purpose of gaining the (tax) benefits" is no reason to apply the anti-tax avoidance Section 269.[26] It would be much less reasonable to depart from the strict "passage of title" rule in determining the source of income of the Western Hemisphere corporation.

7. Methods of Sale

The business problems of passing title outside the United States are such that the tax benefits might be outweighed by the business risks. Ordinarily a United States concern wants dollars rather than foreign currency, and it prefers not to assume the risk of loss after the goods reach the ship. In this situation the goods will be shipped F.A.S. the United States port and payment is made by letter of credit at the time of delivery to the ship and presentation of the title documents to a bank. Clearly, in such case the title will pass within the United States, and the resulting income will not be from the outside-United-States source required for a Western Hemisphere corporation.

a. The foreign branch method. There are a number of accepted procedures for passing title outside the United States, all of which are based on establishing the "place of sale" in the foreign country. The clearest procedure is to create and register a branch operation within the foreign Western Hemisphere country; to ship the goods to the branch abroad; and *thereafter* to make the sale to the foreign customer. The disadvantages of this procedure derive from the dangers of submission to any foreign jurisdiction, which include not only foreign taxation but also the nationalistic tendencies which have been known to culminate in expropriation of property. It has been suggested that the risks could be spread by using a separate Western Hemisphere corporation for each of the foreign countries in which business is carried on, but only the largest exporting companies could afford the luxury of that remedy.

b. The consigned stock method. Another common procedure is to consign the goods to an agent located in the foreign country. An agency agreement acknowledges that title to the goods remains in the selling corporation until delivery is made to the foreign customer. Payment may still be conditioned on the dollar terms of a draft or letter of credit. The principal risk is whether the consigned stock of goods creates a liability for registration and taxation in the foreign country; but this risk may vary with the requirements of the particular country or the effectiveness of the foreign agent. The risk is minimized by some companies which use Panama for a central resting place for consigned goods, thus making sure that a subsequent sale will be made outside the United States.

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[26] *See* footnote 10, above.

c. Export F.O.B. foreign port method. A third method is to make shipment F.O.B. the foreign port, and to require payment against a draft upon arrival of the goods. In this case, the goods are delivered to the buyer only when the draft is paid or accepted, and passage of beneficial title is thus deferred until after the goods have arrived in the foreign country. The manifest advantages of this procedure are that the seller need not maintain a stock of consigned goods in the foreign country and is less likely to be subject to the tax and other laws of such country. Some authorities are concerned that such a transaction would come within the ban of G.C.M. 25131 for having "the primary purpose of tax avoidance," but it is believed that tax avoidance (or minimization) on income from trading in the Western Hemisphere is expressly legalized and condoned by Section 921 of the 1954 Code. If this be recognized, then a transaction should not be criticized or condemned taxwise merely because it is so arranged as to qualify for the benefits extended by Section 921.

8. Comparison with Other Business Forms

A United States business contemplating foreign expansion within the Western Hemisphere has the choice of four principal business forms: (1) an individual proprietorship; (2) a branch operation of a domestic corporation; (3) a Western Hemisphere trade corporate subsidiary; and (4) a foreign corporate subsidiary. Ordinarily, this is the order of preference insofar as concerns simplicity and expense of operation. Selection of the Western Hemisphere or foreign corporate subsidiary form obviously requires a foreign income sufficiently large to produce a substantial tax saving. The tax differential is indicated in the following examples which assume Western Hemisphere foreign net income of $100,000 and United States net income of $100,000.[27]

Farsighted planning might take into account a possible excess profits tax, particularly when we have had two excess profits tax eras within the last thirteen years. If the more recent excess profits tax burden is assumed to be applicable at B (subject only to the $25,000 basic excess profits tax exemption), the United States corporation with a foreign branch operation might have paid $52,500 more taxes (30 per cent of $175,000) and would have a balance of income of only $49,000.[28] Manifestly, a *separate* and independent foreign operation in the Western Hemisphere or foreign corporate form is preferable from the long-term tax standpoint.

The choice as between the Western Hemisphere and the foreign corporation revolves around two principal factors: (1) the 85 per cent dividend received credit applies to dividends received from a Western Hemisphere corporation, but does not apply to dividends received from a foreign corporation; (2) the foreign taxes paid by a foreign corporation produce a proportionate tax credit

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[27] Derived in part from studies and examples set forth in "United States Income Taxation of Private United States Investment in Latin America," *United Nations Publication*, ST/ECA/18, January 20, 1953. New York: International Documents Service, Columbia University Press.

[28] The Western Hemisphere and foreign corporations, having only foreign income, were not subject to the excess profits tax. See footnote 6, above.

	BRANCH OPERATION			
	A U.S. Individual		*B* U.S. Corp.	
Foreign income	100,000		100,000	
U.S. income	100,000		100,000	
Total income	200,000		200,000	
Less foreign taxes @ 40 per cent	40,000		40,000	
Balance before U.S. income tax		160,000		160,000
U.S. tax, tentative	134,640		98,500	
Less foreign tax credit	40,000		40,000	
U.S. tax, final		94,640		58,500
Balance income after taxes		65,360		101,500

	SUBSIDIARY OPERATION			
	C Western Hemisphere Corp.		*D* Foreign Corp.	
Foreign income	100,000		100,000	
Less foreign taxes @ 40 per cent	40,000		40,000	
Balance		60,000		60,000
U.S. taxes, tentative	32,500		Inapplicable	
Less foreign tax credit	32,500			
		0		
Balance as dividend to U.S. corporate parent	60,000		60,000	
U.S. income	100,000		100,000	
Total income		160,000		160,000
U.S. taxes, tentative	51,180[29]		77,700	
Less foreign tax credit	Inapplicable		24,000[30]	
U.S. taxes, final		51,180		53,700
Balance income after taxes		108,820		106,300

to a United States corporation owning 10 per cent or more of its voting stock,[31] but a parent corporation is not entitled to any credit for foreign taxes paid by a Western Hemisphere subsidiary.

Tax rate comparisons may be further simplified if the Western Hemisphere corporate rate is assumed to be 38 per cent (100 − 27 per cent credit = 73 × 52

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[29] \$160,000 less \$51,000 (85 per cent of \$60,000 dividend) = \$109,000 normal tax net income.

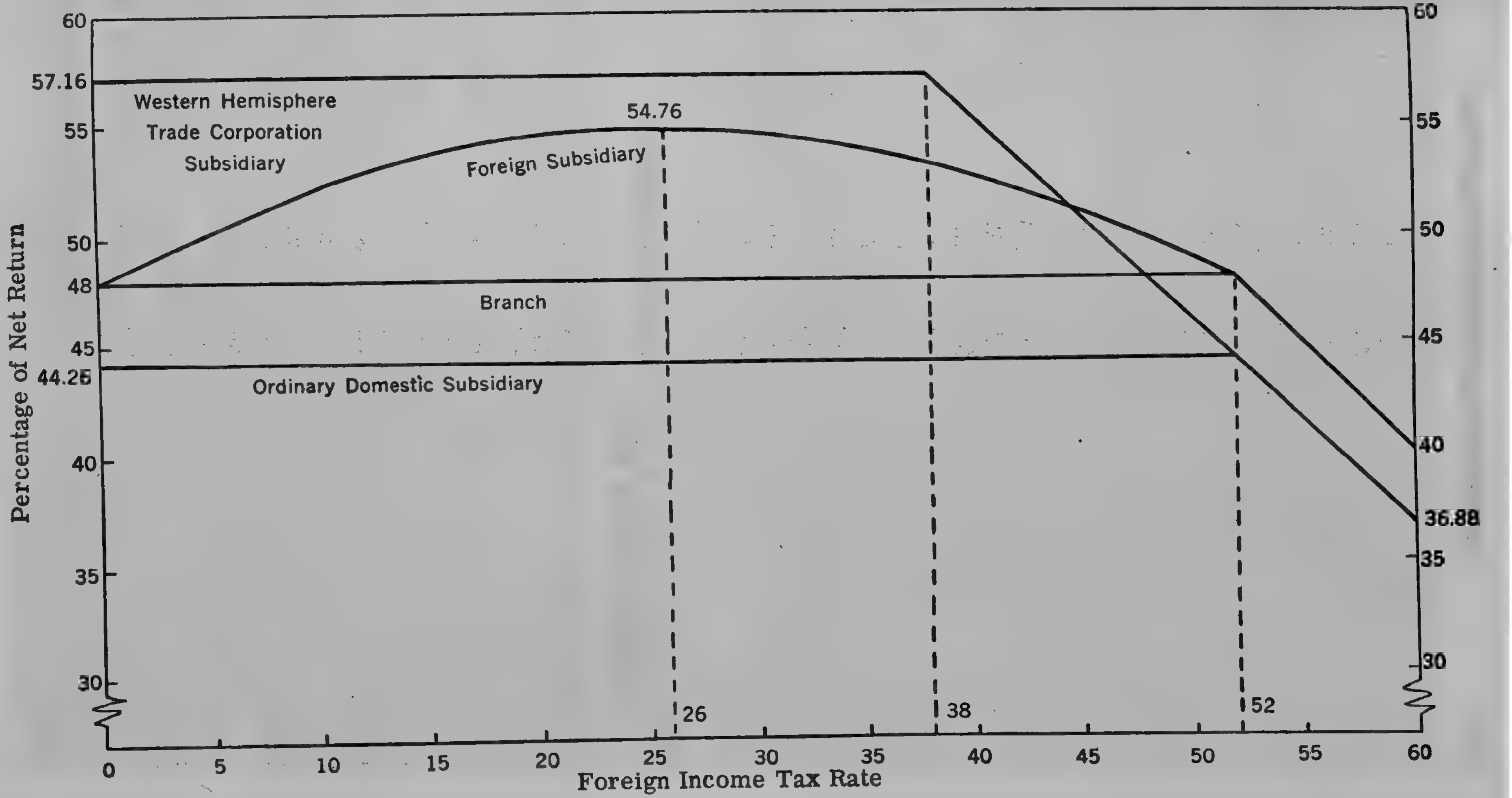
[30] 1954 IRC § 902(a); 1939 IRC § 131(f) foreign tax credit $\frac{60,000}{100,000} \times 40,000$.

[31] 1954 IRC § 902(a); 1939 IRC § 131(f).

Chart A

COMPARISON OF THE FORMS OF INVESTMENT

Percentage of corporate investor's return on foreign earnings after United States and foreign income tax. (Calculations are made for foreign income tax rates between 0 and 60 per cent. At a foreign income tax rate of 52 per cent and above, the Western Hemisphere Trade Corporation curve coincides with the curve of the Ordinary Domestic Subsidiary and the Foreign Subsidiary curve coincides with the curve of the Branch.)



per cent tax rate = 37.96 per cent effective rate).[32] Thus, a corporation qualifying under Section 921 is favored with 14 per cent less tax than the ordinary domestic corporations; and if the Western Hemisphere corporate earnings are distributed as dividends to a corporate parent which pays a 52 per cent tax on 15 per cent of those dividends, the percentage advantage is reduced to about 9.2 per cent. (But note that this tax advantage is enlarged if and when the ordinary domestic corporation is subject to an excess profits tax.)

Comparing the Western Hemisphere and foreign corporate subsidiaries, and assuming a foreign tax rate exceeding 15 per cent, the tax differential after distribution of earnings to a domestic parent corporation is about 4 per cent, favoring the Western Hemisphere subsidiary. This tax differential is about 9 per cent if there be no foreign tax at all; and if the foreign tax exceeds about 44 per cent, the tax differential shifts (because of the Section 902(a) foreign tax credit) to favor the foreign corporate subsidiary over the Western Hemisphere subsidiary.

These comparisons have assumed that the Western Hemisphere corporation paid the same foreign taxes as the foreign corporation. However, the Western Hemisphere corporation probably would pay no foreign tax at all if its export sales were F.O.B. the foreign port, and even the consigned stock method of sale would not result in tax by many foreign countries. In this situation the Western Hemisphere corporation would be subject to only the United States tax approximating 38 per cent, whereas the foreign corporation would be subject to combined foreign and United States taxes (after distribution of dividends to the United States parent corporation) of between 46 per cent and 52 per cent.[33]

9. Factors in Selecting the Western Hemisphere Corporate Business Form

Certain types of businesses are not suited for the Western Hemisphere trade corporation. Where the business includes manufacturing activity in the United States, its sales income will be split and a part attributed to United States sources,[34] thus making it impossible to meet the 95 per cent non-United States gross income requirement of Section 921.

Where the business is the mining and sale of natural resources located in a foreign country which does not allow a depletion deduction, there may be tax disadvantages in using either a foreign or a Western Hemisphere corporation. In this case the only United States tax is paid by the parent corporation on the intercorporate dividends, and this tax could have been eliminated if the foreign business had been set up as a mere branch operation of the parent.

If the foreign business operation will be profitable for only a limited period, following which the accumulated profits are to be channeled into the parent corporation, the Western Hemisphere corporation is the better form of sub-

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[32] This computation disregards the $25,000 surtax exemption which has less significance as income increases.

[33] An excellent and more detailed study of the tax rate comparatives appears in both chart and graph form in *United Nations Publication*, ST/ECA/18, footnote 27, above. *See* Chart A on page 155.

[34] 1954 IRC § 863; 1939 IRC § 119(e); footnote 19, above.

	Subsidiary Operation		
	Foreign Corp.	Western Hemisphere Corp.	U.S. Corp.
Income before tax or depletion	100	100	100
Less foreign tax @ 30 per cent	30	30	30
Balance of income	70	70	70
U.S. income after 50 per cent depletion	...	50	50
U.S. tax (38 per cent and 52 per cent respectively)	...	19	26
Foreign tax credit	...	30	30
Net U.S. tax	0	0	0
Dividend to parent corp.	70	70	70
Dividend-received credit	...	59.5	59.5
Parent's taxable income	70	10.5	10.5
U.S. tax @ 52 per cent[35]	36.4	5.5	5.5
Less foreign tax credit	21.0	0	0
Net U.S. tax of parent	15.4	5.5	5.5

sidiary because it may be liquidated tax free into its parent.[36] The liquidation of a foreign corporate subsidiary ordinarily will produce taxable capital gain for the parent corporation.[37]

But if the foreign business operation is a permanent one, and it is expected that foreign profits will be reinvested, the foreign corporation is preferable because there will be no United States tax on the profits which are withheld from dividend distribution. Moreover, if the stock interest is held by individuals rather than by a parent corporation, it is clear that the foreign corporation will in all cases produce a higher net-after-tax dollar because there would be no United States corporate tax, as contrasted with the corporate taxes which might be incurred by a Western Hemisphere corporation.

A final consideration is that of obtaining a tax benefit from initial years' losses. It is not unusual that the first few years of a foreign operation are devoted to development activities which result in losses; and there may be such losses in one foreign country in the same year in which another foreign country operation produces a profit. If there were separate foreign corporations for each of the business operations, the loss of one could not offset the profit of the other. But a Western Hemisphere corporation which encompassed both foreign operations would make possible the offset of loss against profit. The same logic would suggest that a United States corporation entering the foreign market for the first time, and expecting initial losses, should use the branch operation method rather than a Western Hemisphere subsidiary corporation in which the initial losses might (subject only to loss carry-over provisions) be isolated and produce no tax advantage.

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[35] Assuming that other income of the parent corporation exceeds the $25,000 basic surtax exemption.

[36] 1954 IRC § 332; 1939 IRC § 112(b)(6). But the parent must own at least 80 per cent of each class of stock of the subsidiary.

[37] 1954 IRC § 367; 1939 IRC § 112(i) requires that, as an additional requisite for a tax-free liquidation of a foreign subsidiary under Section 367, the Commissioner shall have made a prior determination that a principal purpose is not avoidance of Federal income taxes. It might be advantageous if, before liquidation, the foreign subsidiary were to distribute its earnings as dividends to its parent corporation, the latter then making use of the foreign tax credit under Section 902(a).

A fair conclusion is that a Western Hemisphere trade corporation generally will produce a combined foreign and United States tax advantage. But conservative planning suggests that each case be studied independently to determine whether the type of business and other factors may not seriously reduce or even eliminate that advantage. Additionally, if only United States export sales are involved, particular care should be exercised in selecting the method of sale (branch, consigned stock, or F.O.B. foreign port) not only with the view of establishing a non-United States income source, but also for the purpose of minimizing the foreign taxes.

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9

When and How to Use Multiple Entities

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The different methods of imposing taxation on corporations, partnerships and individuals result in many tax inequities, despite the permissive method of taxing single proprietorships and partnerships contained in the Revenue Code of 1954.[1] Such permissive elections would seem to be applicable in only a limited number of cases and would still leave the proprietor or the partnership so electing with all the legal disadvantages of an unincorporated business.

The bracket system of imposing income taxes on corporations whereby the first $25,000 of taxable income is subject to a tax rate of only 30 per cent to March 31, 1956, and 25 per cent for taxable years beginning thereafter, providing Congress does not further postpone the reduced corporation rates, results in a substantial saving where a corporation is used by an individual or a group of individuals having even mid-bracket incomes. Furthermore, the use of each additional corporation results in a possible saving of $5,500 per year.

Where sound business purposes relating to management, financing, and other important purposes are available, extensive projects may be segregated into a group of related, though separate, corporations and partnerships effecting important tax saving results. Capital gains at times can be assured through the taking of title to certain property in the name of separate corporations whose business purposes may differ from the primary business purpose of the principal operating entity controlled by an individual or a related group of individuals. Such capital gains might otherwise be denied or the attempt to take them might result in tax litigation. By segregation into a separate corporation the possible denial of capital gain treatment might at least be mitigated through securing the benefit of lower corporate tax rates.

It is safer to segregate a new project into a number of corporations at the time the project is entered into if there are sound business reasons for doing so, thereby securing the $25,000 surtax exemption for each corporation, than to break up a project at a later date in order to secure such benefits. Reference should be made to many other chapters in this book for a more detailed discussion of the tax accounting principles. This chapter will be confined to consideration of the use of multiple entities at the time of the formation of new projects.

A new $60,000 minimum credit is allowed as a deduction from accumulated earnings[2] and profits in determining unreasonable accumulations of surplus. This adds another major advantage for the segregation of projects through the use of multiple entities.

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[1] 1954 IRC § 1361; not in 1939 IRC.

Tax economies must be weighed against the loss of income whenever there is a giving up of stock interest to minority ownership represented by unrelated investors, department managers, or other business associates. The parties must also consider the added expense attendant upon the proper legal and accounting procedures which result from the use of multiple entities. The 1954 Revenue Code materially decreases the penalty of additional legal costs, i.e., incorporation and organization expenses, as such expenses may now be written off over a period of not less than 60 months, beginning with the month the corporation first became active in business.[3] The provision does not apply to fees or expenses in connection with stock issues.

At present there appears to be no legal deterrent to the use of many separate corporate entities by the same or a group of related individual taxpayers, and it would seem from court expressions in certain decisions that one may fully and extensively plan to minimize the tax "take." Future legislation, however, must be carefully watched inasmuch as when the Revenue Bill of 1951 was under consideration there was a proposal to deny all corporations having related controlling stockholders more than one $25,000 exemption from surtax.[4] This proposal resulted in a provision under which there is a possible disallowance of a separate $25,000 exemption from surtax where there is a transfer of property (not cash) from one corporation to another.[5] A more recent proposal made to Congress, during the hearings before the House Ways and Means Committee when the Revenue Act of 1954 was under consideration, was to require all corporations where 80 per cent or more of the stock was controlled by an individual, a family, or a group of partners, to file consolidated tax returns.[6] If such proposal had been enacted into law, obviously the benefits of using multiple or numerous corporations would have been nullified.

A further distinct advantage is that corporations with small income will not be subject to the pay-as-you-go system which only applies where the estimated tax will exceed $100,000.[7]

1. Points to Consider

Sound planning to determine "when" and "how" to use multiple entities suggests consideration of the following points presented in this chapter:

	Section
When to use multiple entities	2
Avoid pyramiding individual, family or principal partner's income	2(a)

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[2] 1954 IRC § 535(c)(2); Not in 1939 IRC.

[3] 1954 IRC § 248(a); Not in 1939 IRC.

[4] Revenue Bill of 1951, H.R. 4473, p. 24; Senate Finance Committee Report, p. 67.

[5] 1954 IRC § 1551; 1939 IRC § 15(c).

[6] Recommendation made to the House Committee during hearings on the 1954 Revenue Act by the American Cotton Manufacturers Institute.

[7] 1954 IRC § 6016(a); Not in 1939 IRC.

Section
- Avoid pyramiding of corporate income . . . . . 2(b)
- Creating children's separate estates . . . . . 2(c)
- Facilitating sale of parts of property at a capital gain . . . . 2(d)
- Capital gains tax on liquidation . . . . . 2(e)
- Accounting methods may differ . . . . . 2(f)
- Creating family foundations . . . . . 2(g)
- Future retirement of partners or stockholders . . . . . 2(h)
- Employee incentives . . . . . 2(i)
- Limited liability . . . . . 2(j)
- Capital financing . . . . . 2(k)
- Increased borrowing capacity . . . . . 2(l)
- Segregating out of state or foreign operations . . . . . 2(m)

How to use multiple entities 3
- Where individual, family or principal partner's income is concerned . . . . . 3(a)
- Where a corporation is already in existence . . . . . 3(b)
- Functional entities . . . . . 3(c)
- Independent entities . . . . . 3(d)
- Joint ventures and limited partnerships . . . . . 3(e)
- Capital structures . . . . . 3(f)
- Avoid thin capitalization . . . . . 3(g)
- Keep adequate records . . . . . 3(h)
- Accumulation of earnings . . . . . 3(i)
- Acceleration of income . . . . . 3(j)

How a multiple setup works out financially (Illustration) . . 4

Conclusion 5

You must survey the present income and the expected income for the next several years of the principal individuals, families, partners and corporations now in existence, as well as attempt to forecast the financial requirements and future income prospects of the new enterprise, department or branch.

Comparisons of applicable and prospective tax rates are not enough; one must take into consideration costs of financing through new or unrelated participants and various other factors. Frequently it will be found that the assured tax economies will more than offset the "after tax" loss of allotting a participation in profits to such new or unrelated participants, even though one is to allow the suggested percentage participation used by many tax attorneys and tax accountants as hereinafter described.

2. When to Use Multiple Entities

a. Avoid pyramiding individual, family, or principal partner's income. The principal tax saving economies through the use of multiple entities can be effected by the prevention of the pyramiding of income in the hands of the proprietor, the family or the principal partners. Under the tax rates applicable under the 1954 Code, the breaking point on individuals, as compared with the use of small separate corporations wherein the income will be under $25,000, is at an approximate $16,000 family (husband and wife) taxable income level. If and when the corporation tax rates drop to the proposed 25 per cent tax on the first $25,000 of taxable income, the breaking point will be at an approximate family taxable income level of $12,000, and at the $10,000 taxable income level for the head of a household, or the $8,000 level where a separate return is filed.

Generally, tax attorneys and tax accountants do not advise the use of multiple entities unless the family surtax net income exceeds $50,000, although it will be found at times advisable to use a separate corporation, the income of which will even be subject to some surtax where the family surtax net income exceeds $30,000.

It is frequently found, particularly among real estate brokers, merchant builders, subdividers, and certain other lines of activity, that tax attorneys and tax accountants have recommended that outside investors own in excess of 5 per cent of the voting stock in any new corporation. Their recommendation was based upon the expectation that Congress might at any time deny the $25,000 surtax exemption to more than one corporation in a related group if at least 95 per cent of the voting power of all classes of stock was owned directly by one or more corporations, or was owned, directly or indirectly, by certain related individuals. Such relationships might have included certain members of the family, partners, etc., as well as controlling stockholders in one or more of the corporations.

Other tax attorneys and tax accountants have been mindful of the danger, such as was proposed at the time of the hearings by the House Ways and Means Committee on the Revenue Act of 1954, that all related corporations be required to file consolidated income tax returns.[8] Such conservative-minded tax attorneys and tax accountants have consistently advised minority independent ownership of at least 21 per cent of the voting stock. Such advisers were also cognizant of the structural changes enacted in the Revenue Act of 1951 denying a newly organized corporation or a dormant corporation a $25,000 surtax exemption where such new or dormant corporation received property from another corporation, providing if after the transfer and during any part of the taxable year the old corporation or its stockholders, or both, owned 80 per cent or more of its voting stock or 80 per cent of the total value of its stock.[9]

It is interesting to note the summary prepared by the Staff of the Joint Committee (of Congress) on the changes made by the Revenue Act of 1951 on Internal Revenue Taxation in respect to the surtax exemptions:[10]

> This provision of the bill does not prohibit or discourage expansion of an existing business accompanied by the formation of new corporations, as distinguished from the mere split-up of an existing business nor does it prevent an individual or a group of individuals who may own the stock of a corporation from forming additional corporations to engage in a similar or a different business. A corporation wishing to expand its activities may use a part of its funds, whether or not those funds represent accumulated earnings, to form the capital of a new corporation, acquiring the stock of the new corporation in exchange for those funds. Or an individual who owns all the stock of a corporation may use any cash or property he owns to form a new corporation. In such cases the new corporation will be allowed the full surtax exemption and the minimum excess profits credit.

If the parties deal in good faith and at arm's length, a stockholder-corporation transaction will be upheld for tax purposes. Two very important cases which develop the reasoning of the Courts are the *Stearns Magnetic Mfg. Co.*,[11] a case which related to the assignment of patents to controlling stockholders and the subsequent payment of royalties to such stockholders; and an earlier case, *Chamberlin* v. *Commissioner*[12] wherein the Second Circuit Court of Appeals said:

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[8] *See* footnote 6, above.

[9] Sec. 121(f) of the 1951 Revenue Act added subsection (c) to 1939 IRC § 15(c); 1954 IRC § 1551.

[10] 1951-2 Cum. Bulletin, p. 503—last paragraph.

> If the parties deal fairly with one another, it matters not whether their aim be to avoid taxes or to regenerate the world.

b. Avoid pyramiding of corporate income. Due to the bracket system of imposing a 22 per cent higher tax on income over the $25,000 level, it will be found advisable at the time of inception of a new project, branch, or department, to form a separate corporation, preferably through the use of new money and not through the transfer of property from any presently owned or controlled corporation.

In Section (a) above, the applicable provisions both proposed and enacted in the Revenue Acts of 1951 and 1954 are discussed.

c. Creating children's separate estates. It is frequently found advisable to form new partnerships, limited partnerships, or separate corporations by making a gift of the necessary capital to the taxpayers' children or other relatives in order to create a fund for the building up of the children's or relatives' separate property interests. A gift of money represents a definite measurable gift, whereas a gift of property, consisting either of the capital stock in a "close" corporation or of an interest in a partnership, may have a "fair market value" difficult to accurately determine, and there may also be a "basis" problem.[13]

d. Facilitating sale of parts of property at a capital gain. Real estate dealers, subdividers, and merchant builders particularly, will frequently find it advisable to create multiple entities (either new separate corporations or partnerships) when a new acquisition is first contemplated.

Real estate dealers, it appears, will have as much or more difficulty under the provisions of the Revenue Act of 1954[14] in receiving capital gains treatment, even when engaged in a limited real estate subdivision, as formerly. It is quite possible that these provisions will likewise be extended to merchant builders, and therefore both groups will find it advisable to have rental properties owned in small groups by separate corporations or by separate partnerships. Merchant builders particularly have experienced severe tax penalties or disputes upon the disposal of rental properties even where such properties have been held for a period of years.[15] Many have suffered years of tax litigation and expense.

The importance of forming a separate corporation for a project to hold rental properties, where one has other activities either in connection with the sale of real estate or merchant building, can best be illustrated by a recent decision of the U.S. Circuit Court for the Tenth Circuit No. 4592 under date of June 12, 1953.[16] In that case two real estate partners joined with two lumber dealers in 1942 in the formation of a corporation, "Victory Housing No. 2—Inc.," for the purpose of constructing and renting 84 single rental units. Forty-two of those units were sold during a six-month period in 1946. The Circuit Court reversed and remanded the decision of the Tax Court in 18 T.C. 466 and held that the single factor of numerous sales, even though during a short period of time, was not decisive of a change in the character of the business.

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[11] *Stearns Magnetic Mfg. Co.* v. *Commissioner* (7 Cir. 1954), 208 F. 2d 849, 45 AFTR 41.

Three recent cases involving troubles when corporate and personal affairs mix: *Peter Stanos*, 22 T.C. No. 108; *Earl Z. Perry*, 22 T.C. No. 117; *Payne Housing Corporation*, Docket No. 37533, T.C.M., opinion of June 30, 1954.

[12] *Chamberlin* v. *Commissioner* (6 Cir. 1953), 207 F. 2d 462 at 469, 44 AFTR 494.

[13] You are referred to pertinent chapters in this book respecting these problems.

[14] 1954 IRC § 1237; Not in 1939 IRC.

[15] *McGah* v. *Commissioner*, 17 T.C. 1458 (1952)—on remand from 9 Cir. 193 F. 2d 662, 41 AFTR 639. Rehearing 210 F. 2d 769, 45 AFTR 386, reversing the Tax Court.

Rollingwood v. *Commissioner* (9 Cir. 1951), 190 F. 2d 263, 40 AFTR 1006.

Also see section entitled "Sale of Houses Originally Built for Investment or Whither Section 117(j)? *Proceedings of New York University Twelfth Annual Institute on Federal Taxation*, pages 109-126. New York: Matthew Bender and Company, 1954.

The provisions respecting "collapsible corporations"[17] will, of course, bear watching, as will the important changes in the Revenue Code which now preclude the use of "collapsible partnerships."[18]

If small parcels of rental real estate are held in separate corporations, it is frequently possible to sell a part of the interest or all of the capital stock of such corporation and be assured of capital gains treatment, providing the holding period or other factors do not bring into effect the provisions relating to collapsible corporations.

It is frequently found that incorporated real estate investors who hold title to numerous pieces of property may at a later date find it advisable to sell or distribute certain properties. Sometimes great difficulties are experienced in withdrawing such properties from the corporate entities without the imposition of heavy taxes, whereas if each substantial piece or small group were separately incorporated there would be more flexibility.

e. Capital gains tax on liquidation. The collapsible corporation provisions do not apply if a corporation has held the property for a period of over three years, even though more than 70 per cent of the gain is attributable to the increase in value (over cost) of such property manufactured, constructed, produced, or purchased. Thus it is still possible, where one is certain of an increment in value over a period of years, to have a corporate entity hold real estate or other property, dispose of the stock after three years or cause the corporation's liquidation and receive the benefit of the capital gains rate on the increment rather than be subjected to the ordinary rates.[19]

f. Accounting methods may differ. It is possible through the formation of a new corporate entity to adopt a different accounting method than that used in connection with the other existing business operations. The new provisions of the Revenue Code of 1954 permit varying methods but there remain many limitations and restrictions. A few of these methods may be briefly set forth:

1. Adoption of the cash method where other operations are on the accrual method, or vice versa,

2. adopting a different depreciation method where a corporation failed to elect to use the new permissive methods on additions made after December 31, 1953.

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[16] *Victory Housing No. 2, Inc.* v. *Commissioner* (10 Cir. 1953) (revising and remanding 18 T.C. 466), 205 F. 2d 371, 44 AFTR 80.

[17] 1954 IRC § 341; 1939 IRC § 117(m). See also other chapters herein.

[18] 1954 IRC § 751; Not in 1939 IRC.

[19] *See* footnote 17, above.

As an illustration, if present depreciable assets are depreciated on the "straight line" method, it is generally found advisable to place rental properties or properties having a short life on one of the "accelerated" depreciation methods.[20] In that manner, higher write offs may be secured in the early years with a possible larger capital gain upon the sale of the asset at a future date, and,

3. adoption of a different fiscal year.

g. Creating family foundations. Frequently a family charitable foundation, trust or corporation, may be desirable. Such corporation or trust may particularly be useful in holding real estate or other investments which have substantially appreciated in value. As an illustration, it is possible to transfer appreciated property to such a corporation or trust, once it has qualified, and the donor will avoid payment of a tax on the gain and may receive a deduction for a donation based on the fair market value thereof. Of course it should be understood that such a foundation is limited in the business activities in which it may engage. Many huge estates have been conserved in this manner.[21]

Considerations relating to legal or business purposes include:

h. Future retirement of partners or stockholders. The use of multiple entities is frequently desirable particularly where it is thought a partner or a stockholder in a separate project, department, or branch may desire to withdraw his participation or investment in the near future. In such cases the use of multiple entities will facilitate such withdrawal or partial liquidation without disturbing the structure of a larger, more involved organization.

i. Employee incentives. Key employees, having the management of responsible departments or projects, may be permitted to participate in the profits of their particular activity through being permitted limited investments either in the stock of separate corporations or in separate partnerships. It is possible for an employee to receive a larger portion of the stock of a small corporation or a partnership with more beneficial employee relations than is practical in a large organization.

j. Limited liability. It is possible to limit liabilities through the use of multiple corporations. Such limitations of liability may relate to losses, damage claims, and various other types of possible law suits. As an illustration, it is said that there is one taxicab organization in New York operating over 600 taxicabs where the liability risks are reduced by ownership among 30 small corporations.[22] In this manner a suit against one does not affect the major part of the business. With the courts granting excessive personal injury claims, the use of multiple corporations serves a valuable business purpose. Of course the tax savings can also be substantial.

One real estate developer recently testified he had an interest in "some 200 or 300 corporations," apparently with one builder.[23]

Certain chain store operators have found it advisable to separately incorporate each store in order to limit their liabilities under leases.[24]

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[20] See Chapter 29, "How to Get Maximum Deductions for Depreciation," by Aaron Holman.

[21] See Chapter 4, "How to Organize and Operate a Tax-Exempt Company," and Chapter 84, "How to Use Charitable Trusts and Foundations."

[22] J. K. Lasser, *J. K. Lasser Report on Taxes*, October 15, 1952, p. 2.

[23] Testimony before Senate Banking Committee in Los Angeles in 1954.

[24] *Berland's Inc. of South Bend* v. *Commissioner* (1951)—16 T.C. 182.

k. Capital financing. It is frequently possible to induce an outside investor to more readily invest in small separate corporations which own particular properties that are known to him and in which he is interested. Likewise, limited partnerships offer more appeal and protection to the investor than general partnerships.

l. Increased borrowing capacity. It is frequently found, particularly in connection with state banks, that the banks' loaning capacity is severely limited in the amount they may loan to any one borrower. In some states it is possible to increase the borrowing capacity by the expediency of creating separate entities for separate stores or separate projects.[25]

m. Segregating out-of-state or foreign operations. Frequent difficulty is experienced through overlapping state franchise taxes. In some cases this reason alone may be sufficient to warrant the use of a separate entity.

Western Hemisphere corporations are granted certain exemptions.[26]

3. How to Use Multiple Entities

Some of the procedures and points to be considered in the use of multiple entities are:

a. Where individual, family, or principal partner's income is concerned. In Section 2(a), the breaking level was discussed as well as the level at which many tax attorneys and tax accountants advise the use of multiple or numerous entities. Each individual, family or group of partners presents different problems. For that reason it is best for the practitioner to determine in each individual case the level at which to suggest the use of multiple entities. The adviser should secure the following information in order to determine this level:

1. Present regular sources of income of the individual.
2. Recurring fully deductible business expenses.
3. Interest, taxes, contributions, etc., of a non-business nature.
4. An estimate of the individual or the family's required "free" income per year for at least the next two or three years, i.e., net income after both federal and state taxes, living and personal expenses needed.
5. Life insurance cost or other required savings or committed investments.

Having the above estimates it is then possible to compute the amount of taxable income per year which will enable the individual or family to meet their requirements. It is, of course, well to allow some margin for unusual expenditures such as improvements to the residence, new furniture, severe illnesses, etc. A few tests made by the individual practitioner will indicate why some tax advisers extend the $50,000 suggested level even to the level of $70,000-$75,000 per year.

Once the level of continuing income desired is determined, it is possible to create new entities to carry on the activities with greater freedom for the individuals, families, and principal partners. The use of property, where desirable, must be carefully considered as with the transfer of property from one corporation to a new corporation the exemption and the credit will be denied[27] unless the transferee can show by a clear preponderance of evidence that securing the $25,000 surtax exemption or the $60,000 accumulated earnings credit was not the motivating purpose of the transfer.

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[25] *Alcorn Wholesale Co. v. Commissioner* (1951)—16 T.C. 75.

[26] *See* Chapter 8, "Western Hemisphere Corporations."

Also, *see* section entitled "Some Tax Aspects of International Operations," *Proceedings of New York University Twelfth Annual Institute on Federal Taxation*, pages 785-890. New York: Matthew Bender and Company, 1954.

b. Where a corporation is already in existence. The principal problem in respect to the use of multiple entities, where a corporation already supplements the individual, family, or partnership business structure, is the commitments the corporation has already made, its requirements for continuing or increased income, and its needs in order to reduce indebtedness or otherwise perform under its contracts.

Where new departments, branches or projects are undertaken, the use of money instead of other property is still undoubtedly advisable since under the Revenue Act of 1954 there may be a contingency of taxable compensation or gifts in the transfer of property.[28]

Consideration must be given to the permanency of the present favorable climate existent for tax planning considerations. Looking forward to a period of many years of operation of the new corporation may indicate the advisability of setting up a new unrelated stockholder having an interest in excess of 5 per cent and possibly up to 21 per cent.[29]

c. Functional entities. Many new projects are segregated into separate entities following a functional pattern.

The use of a functional pattern is quite frequent among merchant builders who will use one entity to buy the land and subdivide and other separate entities to perform such functions as land improvements, foundation, brick, cement or stucco work, plumbing, and so on. The dangers here lie principally in the need for frequent review of any apportionment of income and expense to the various separate entities, and even though these separate entities may contract to perform on a cost plus expense, plus either a fixed fee or a fixed percentage of profit, there may be problems under Section 482 of 1954 Code. Frequently radical changes occur in costs or expenses and profit margins during the course of a project; therefore, there is need for frequent review and adjustments. Adjustments are also fraught with danger.[30]

d. Independent entities. Independent entities, standing firmly on their own feet as the owner of separate properties and contracting for their improvement and sale, are believed to be more sound from a tax standpoint. Again, merchant builders are frequent users of such independent entities. A group of such independent entities, each having one or more separate unrelated stockholders or partners, may join together to buy undivided interests in a piece of land. A separate agency corporation may be formed for the purpose of holding title to the land as an agent for the group of corporations, contracting for the land improvements, and then transferring title to separate lots proportionately to each of the entities in the "owning" group. Usually such services are performed for cost plus expenses plus a reasonable nominal fee. In some cases, it has been possible to secure title insurance companies or escrow holders to sign maps and perform such services. The owning entities then individually contract with a licensed contractor for the construction of the houses either, at a fixed contract price, or on the basis of cost and expense plus a fixed fee, or a fixed percentage of cost. Each member of the group likewise contracts for the sale of the residence with a licensed realtor or sales agency. It is believed that this type of organization stands on stronger ground than the functional type of organization inasmuch as it is generally possible to substantiate the reasonableness of a contractor's fee and the fee upon the sale. Obviously, sales representatives do not require as high a fee where selling a large number of homes as where selling only a single unit.

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[27] *See* footnote 5, above.

[28] 1954 IRC § 351(d); § 351 takes the place of § 112(b)(5) of the 1939 IRC with certain modifications.

[29] *See* discussion in Section 2(a) of this chapter.

[30] Adjustments made as to costs or fees are usually reviewed by Revenue Agents upon examination of a taxpayer's return. They frequently result in a more critical review than would otherwise be made.

This discussion as to the organization of the entities along a functional line and those standing on their own feet applies to other business activities as well as to merchant builders.

It is obvious that in all dealings between related corporations or partnerships a test of the "arm's length" dealings must stand the scrutiny of the Commissioner of Internal Revenue.

e. Joint ventures and limited partnerships. Some tax attorneys have advised merchant home builders to form limited partnerships or joint ventures and have a related group of partnerships and corporations as their members. In many cases an outsider or a superintendent has a small interest as the general partner, or he with one or two of the corporations may act as the general partners. This interest is sometimes limited to 1 to 5 per cent of the profits of the enterprise. This writer sees too many danger signals which can lead to the "shotgun attack" of the Commissioner. An article by S. V. Ekman in the publication of the *Twelfth Annual Institute on Federal Taxation of New York University*, page 693, on "Warning Signals Under Sections 45 and 129 of the 1939 Revenue Code," discusses the impetus of the Revenue Act of 1950 with the minimum $25,000 surtax and excess profits credit as the cause of the formation of multiple corporations. He describes the Commissioner's attempt to invoke Sections 45 and 129 of the 1939 Code, now replaced by Sections 482 and 269 of the 1954 Code, and concludes that the Commissioner has not succeeded in consolidating income, but only in distributing income in transactions between a related group, and that not a single case brought by the Commissioner has been decided in the Commissioner's favor under Section 129. However, he perceives a "shotgun attack" using all available sections at all times in new cases. In the Advance Machinery case[31] the Commissioner succeeded in combining the income of three corporations and one sole proprietorship as the income of one corporation. The use of limited partnerships with some of the corporations being general partners and others as limited partners raises the question as to whether the income might be consolidated by the Commissioner holding the group to be taxable as an association, hence as a single corporation. In joint ventures and limited partnerships there generally must be a high measure of delegation of authority, and such delegation of authority is one of the important tests used by the Commissioner to determine whether or not a taxable entity exists. There are many dangers inherent in joint ventures and limited partnerships, and the more one attempts to avoid delegation of authority and other tests used by the Commissioner, the more one is apt to cause other possible legal difficulties. Dissension among the participants, death, or other occurrences are ever-present dangers inherent in joint ventures and limited partnerships.[32]

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[31] *Advance Machinery Exchange, Inc.* v. *Commissioner* (2 Cir. 1952), 196 F. 2d 1006, 41 AFTR 1362, cert. den. 344 U.S. 835.

f. Capital structures. Where it is desirable to have an outside unrelated investor provide the greater part of the capital required in a new venture, branch, division, or department, it may frequently be advisable to cause the capital structure of the corporation to be divided into several classes of stock or to provide for bonds or debentures.

A precautionary note should be sounded to the effect that where the entities must secure Federal Housing Administration loan insurance, the use of debentures or bonds in a corporate structure is generally considered "secondary financing" by the Administration, and therefore, the property may not qualify for insured loans.

In such instances the use of preferred stock is often desirable. The outside or unrelated investor generally subscribes to all or most of the preferred stock which carries a prescribed reasonable dividend plus a redemption price which frequently increases with the running of time. In this way the outside investor receives a reasonable return on his capital plus a measure of capital gain upon redemption. A cautionary note must be inserted here that the ratio of ownership of the preferred and common stock should vary widely. Generally this is taken care of by the interest of the promoter, the subdivider, or the contractor who will insist on receiving a controlling interest in the common stock. The common stock should require some investment to assure that the redemption of the preferred stock will not be held to represent a taxable dividend under Section 302 of the Revenue Code of 1954. Care must be taken at the time of retirement of preferred stock or partial liquidations so that nothing is done which will prevent participating investors from securing capital gains treatment. The new provisions of the Internal Revenue Code of 1954 set up certain definite measures to facilitate the securing of capital gains treatment.[33]

g. Avoid thin capitalization. The temptation is great to form multiple corporations, particularly with small capitalization, and use loans to help finance the business. There is a danger in such cases that the repayment of the loans may be held to be a distribution of earnings and be taxable as a dividend.[34] Even where small capitalization will suffice for long-pull transactions of the corporation, it is advisable for loan financing to come from banks or unrelated persons. This can frequently be implemented by the principal stockholders pledging their separate securities under a form of loan guarantee.

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[32] *See* Rabkin and Johnson, *Current Legal Forms*, chapter on Joint Ventures, Syndicates and Associations. New York: Matthew Bender and Company, 1955. See also a brief discussion "Limited partnership—Taxable as a Partnership or as a Corporation?" Roy J. Moceri, *Washington Law Review*, University of Washington, August 1952, page 232.

[33] 1954 IRC § 302; 1939 IRC § 115(g)(1).

Frenette v. *Bradnick* (D.C. Kan. 1954), 1954 P.H. Par. 72, 682.

See David H. Wilson, "Stock Redemptions as Dividends," *Taxes*, Sept. 1954, Vol. 32, page 718.

See Edward Fiest, "Use of Corporate Funds to Buy Out Shareholders." *Proceedings of New York University Twelfth Annual Institute on Federal Taxation*, page 191. New York: Matthew Bender and Company, 1954.

See Wilbur H. Friedman, "Acquisition of Corporate Funds at Capital Gain Rates," *Proceedings of New York University Twelfth Annual Institute on Federal Taxation*, page 215. New York: Matthew Bender and Company, 1954.

h. Keep adequate records. In using multiple entities, care should be exercised to keep adequate records for each separate entity. Each corporate entity should obviously have its own separate minute books, bank accounts, books of original entry, journals, and general ledger. Separate financial and operating statements should be prepared and everything should be done to show and preserve the reality of the separate entity.

i. Accumulation of earnings. The use of multiple corporations has previously required eternal vigilance to plan the group's activities in order to avoid the improper accumulation of earnings. With numerous corporate entities having different fiscal year ends, constant care had to be exercised to see that each corporation had a commitment or a project requiring the beneficial use of its accumulated earnings. The new $60,000 exemption on accumulated earnings[35] gives more leeway but here, too, care must be exercised to avoid the transfer of property from a related corporation.

j. Acceleration of income. Great care must be exercised, particularly where multiple partnerships are used, to avoid the acceleration or pyramiding of income caused by a partner who retires or sells his entire interest. Where a partner dies, the new Revenue Code[36] does not require the closing of the taxable year of a partnership prior to the normal close of the partnership's taxable year.[37] It will suffice to remind the reader that in using multiple partnerships there is an ever-present hazard of pyramiding income in a year least desirable.

Such acceleration can also occur in respect to corporations; an example is where profit has been deferred on the installment sales method, or where the completed contract method of accounting is used for long-term contracts. The dissolution results in all unrealized income falling into the final period of corporate operation.[38]

4. How a Multiple Corporation Set Up Works Out Financially

Let us take a supposititious case to see how a multiple corporation set up might work out from the standpoint of an unrelated group of interested parties.

1. Assume a landowner possesses 120 acres of land suitable for subdivision into 600 home sites, the value of which in its raw state is $120,000. He is willing to participate in the development of the land, but he desires protection from liabilities. He insists on participating in part of the profits resulting from subdividing the land,

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[34] *See Houck* v. *Hinds* (D.C., W.D. Okla. 1954), 1954 P.H. Par. 72, 405.

Frenette v. *Bradnick*—footnote 33, above.

See Joseph Robin, "Fat Advantages of the Thin Corporation," *Taxes*, July 1954, Vol. 32, page 572.

See Herbert Fuchs, "Thin Incorporations—Debt or Stock?" *The American University Tax Institute Lectures*, 1953, Vol. 5, page 141.

[35] *See* footnote 2, above.

[36] 1954 IRC § 706(c).

[37] *See* other chapters in this book for further discussion of these subjects.

[38] I.T. 3586-1942-2 C.B. 65; 1954 IRC § 453(d); 1939 IRC § 44(d).

improving it with individual family residences, and the sale of these residences. He has a substantial income, his top bracket income being subject to income tax at 72 per cent or more. The landowner is interested in capital gains. He desires the project completed in two years.

2. Assume a Contracting Partnership, experienced in subdivision, home building and sale. The principal partners already are assured of income in the coming two years sufficient to cover their necessary living expenses, required savings, and investments. Assume further that the two partners each have a family (husband and wife) taxable net income now placing them in a tax bracket of 66 per cent (Net Federal and State). Their capital is largely tied up in going projects.

3. Assume land improvement costs will run approximately $5,000 per acre, and that it is necessary to roll the project at a rate of about 100 houses per unit or 20 acres at a time in order to permit of cost economies. Assume that in order to provide a working fund to take care of some advance work such as water, sewer, or drainage other than on the unit immediately being developed, a fund of $50,000 should be provided.

4. Assume Federal Housing Administration financing is available, the servicing bank will make construction loans available but will require of the contracting partnership or corporation the following:

(a) They must guarantee completion of the homes within the capital structure of any related corporations and the F.H.A. loans, and the completion to meet all F.H.A. inspection requirements.

(b) They must have working capital (in the contracting partnership or corporation) of $600 per home in progress or $60,000.

(c) They must defer taking any fee until the homes are sold.

5. Assume a potential profit of $1,000 per home (prior to income taxes) is possible over and above a fee to the contracting partnership. Assume further that a fee of $250 per house is reasonable upon such quantity production.

Summary on 600 Homes

Land present value	$120,000
Land Improvement Fund	
20 acres @ $5,000	100,000
Advance or additional working capital	50,000
	$270,000
Contractors Working Fund	$ 60,000
Potential Profit on Sale of Homes	
600 × $1,000	600,000
Contractors Potential Income	
600 × $250	150,000
In 2 years there will result in Potential Profit on Sale of Homes per Year	$300,000
Contractors Potential Income per Year	$ 75,000

Suggested Set Up

1. Twelve "Owning" corporations are to each acquire 1/12th undivided interest in the land, the contract for subdivision, and the improvement and sale. Each will

subsequently receive 50 building lots with completed homes thereon, sell the same and have a potential profit of $50,000 spread over two years. This will give the maximum tax economy.

Capital structure suggested for each:

6 Per Cent Preferred Stock to Landowner	$ 10,000
6 Per Cent Preferred Stock to Unrelated Investor for cash (Redeemable in 15 to 27 months at 110, and at increasing premiums thereafter)	10,000
Common Stock to Landowner 25 Per Cent	625
Common Stock to Unrelated Investor 21 Per Cent	525
Common Stock to 1 or more of individuals in Contracting Entity 54 Per Cent	1,350
Capital of Each "Owning" Corporation	$ 22,500
By 12 Corporations	× 12
Capital of Group of "Owning" Corporations	$270,000

2. For the "Contracting" entity we may use either,

(a) a "Limited Partnership" in which case a limited partner might contribute most of the capital in exchange for the chance to share in the potential profit of $150,000. Let us assume he is to share equally with two working partners. It will readily be seen the working partners face a pvramiding of an additional $25,000 per year income upon which after Federal income taxes they will retain about 34 per cent or $8,500 per year, or we may use,

(b) a new corporation giving an investor preferred stock, plus a smaller amount of common, due to preference on redemption, let us say:

6 Per Cent Preferred Stock to Investor for Cash (Redeemable in 15 to 27 months at 110 and at increasing premiums thereafter)	$50,000
Common Stock Active Officers—75 Per Cent	7,500
Common Stock Active Officers—75 Per Cent	7,500
Capital of Contracting Corporation	$60,000

For the purpose of this illustration we will assume each officer devotes half time to the business of the corporation and that a reasonable salary will be $7,500 per year each. ($7,500 × 2 Officers × 2 years = $30,000)

Thus our "Contracting" Corporation would have:

"Potential" Profit per year	$60,000
Less: income tax (Assuming 1955 Rates)	25,700
Leaving	$34,300
× 2 for two years	$68,600
Deduct: Dividends 27 months @ 6 per cent per annum on $50,000 preferred stock	(6,750)
At Time of Liquidation	
Redemption Premium on $50,000 Preferred Stock	(5,000)
Remainder upon liquidation for common stock	$56,850
25 per cent for investor	$14,212
37½ per cent for *each* of 2 active officers	$21,319

Here it will be seen that our participants will receive:

	Investor	Each Active Officer
Ordinary Income		
Dividends	$ 6,750	
Salary (2 years)		$15,000
Capital Gain		
Preferred Premium	5,000	
Gain on Common Stock	14,212	21,319
TOTAL	$25,962	$36,319

Our "Active Officers" will each retain after federal income taxes approximately:

34 per cent of $15,000 salary—2 years, or	$ 5,100
75 per cent of $21,319 gain on common stock, or	15,989
Retention	$21,089
Comparing with $8,500 × 2, or (See 2(a) above)	$17,000

Let us return now to our "Owning Corporations" and see how our participants will fare:

Each Corporation Potential Income per year	$ 25,000
Less: Federal Tax (Assume 30 per cent rate continues)	7,500
Remaining after Federal Tax	$ 17,500
	× 2
Net Profit after Tax for 2 years	$ 35,000
Deduct: Dividends 27 months at 6 per cent per annum on $20,000 Preferred Stock	$(2,700)
Redemption Premium on $20,000 Preferred Stock	(2,000)
Remainder for Liquidation	$ 30,300
25 Per Cent to Landowner on Common Stock	$ 7,575
21 Per Cent to Unrelated Investor on Common Stock	6,363
54 Per Cent to Active Officers on Common Stock	16,362
	$30,300
$30,300 × 12 (corporations) equals	$363,600

If we had used only one corporation we would have had:

Potential Income per year	$300,000
Less: Federal Tax 52 per cent less $5,500 (Assumed Rates)	150,500
Remaining after Federal Tax	$149,500
	× 2
Net Profit after Tax for 2 years	$299,000
Deduct: Dividends 27 months at 6 per cent on $240,000 Preferred	(32,400)
Redemption Premium on $240,000 Preferred	(24,000)
Remainder for Liquidation	$242,600

$363,600 less $242,600 equals $121,000 tax economy.

Of course with a group of smaller corporations we will have increased bookkeeping, office, stationery, legal and accounting expense. These are apt to be offset by not requiring S.E.C. registration and in some states lower franchise or income taxes.

These examples obviously are not worked out to all the small details but should suffice to illustrate some of the possibilities in financing and tax economies.

5. Conclusion

In summary we have seen that it is easy to form, split up, merge, and liquidate multiple entities. Obviously great care must be exercised in supervising any such multiple set up, as the Treasury Department will undoubtedly carefully scrutinize any transaction between related interests that may not be well founded on business purposes and economic reality.

There are very real disadvantages in the use of multiple entities. They may be dismissed with a mere mention as in each case they require individual appraisement. Briefly, the principal disadvantages are:

1. Increased bookkeeping and office expense.
2. Additional legal and organization costs, part of which are deductible only at the time of liquidation.
3. Additional audit and ordinary legal expenses.
4. Loss of one corporation may not be offset against income of another without the use of consolidated returns, which are only permitted affiliated corporations under restricted conditions.

Caution and constant supervision are the price of tax economies through the use of multiple entities.

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Part II

REORGANIZING THE BUSINESS

10

Corporate Distributions and Adjustments

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The Internal Revenue Code of 1954 attempted to recodify the basic problem areas of corporate taxation. Possibly the most complicated, and the most controversial, of the changes contemplated involved Subchapter C, relating to corporate distributions, liquidations, exchanges and reorganizations, and carryovers. The more radical revision proposed by the House of Representatives was subdued by the Senate. The statute as enacted represents only a modification of the structure of the Internal Revenue Code of 1939, eliminates certain inequities, and reflects a more modern attitude toward corporate rearrangements. Whole areas of existing case law have been left untouched,[1] and other questions find intended answers contained only in committee reports.[2]

1. Points to Consider

Section
Distributions 2
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Corporate Organizations and Reorganizations 4
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[1] Such as "business purpose," "continuity of interest," "step transactions," definition of a "security," and "thin corporations."

[2] See H.R. (Conference) Rep. No. 2543, 83rd Cong., 2d Sess. 41 (1954) discussing judicial and administrative treatment of liquidations followed by reincorporation; Sen. Rep. 1622, 83rd Cong., 2d Sess. 250 (1954) detailing the allocation of earnings and profits in certain corporate distributions. New lines of inquiry, such as what constitutes the active conduct of a trade or business, or a partial liquidation, have been opened up.

Section
  - Basis . . . . . 4(c)
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  - Stockholders in reorganization . . . . . 4(e)
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  - Exchange of stock for stock in same corporation . . . . . 4(h)
  - Holding period . . . . . 4(i)
  - Treasury stock . . . . . 4(j)
- Carryovers 5
  - Carryovers in corporate acquisitions . . . . . 5(a)
  - Limitations on the acquisition of corporations with net operating loss carryovers . . . . . 5(b)

2. Distributions

Subchapter C defines three specific types of corporate distributions which can be made short of complete liquidation:

1. A distribution treated as a dividend;[3]
2. A distribution treated as a redemption and a purchase of stock;[4]
3. A distribution in partial liquidation.[5]

a. Effect of distribution upon corporate distributor. The rule of *General Utilities & Operating Co.* v. *Helvering*[6] has been codified: no gain or loss is recognized to a corporation distributing property "with respect to its stock." Also enacted by indirection is the doctrine that corporate earnings and profits are not adjusted because of the distribution of property which has increased or decreased in value.[7]

To these general rules there are exceptions:

1. Gain or loss is recognized to a corporation upon the distribution of an installment obligation.[8]

2. The distribution of inventory assets held under the "last-in-first-out" inventory method results in gain recognized to the distributor, in the amount by which the basis of such inventory assets on the "first-in-first-out" exceeds the basis computed on the "last-in-first-out" method. No losses are taken into account.[9]

3. A distribution of property where the stockholder either assumes a liability, or takes the property subject to a liability that exceeds the adjusted basis of the property, produces gain to the distributing corporation in the amount of such excess.[10]

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[3] 1954 IRC §§ 301 and 316.

[4] 1954 IRC § 302. Part I of Subchapter C relating to distributions and redemptions takes effect June 22, 1954. 1954 IRC § 391.

[5] 1954 IRC §§ 331(a)(2) and 346.

[6] 296 U.S. 200 (1936).

[7] 1954 IRC § 312. *See Commissioner* v. *Timken*, 141 F. 2d 625 (6 Cir. 1944); *National Carbon Co.*, 2 T.C. 57 (1943), app. dism. (2 Cir., Dec. 7, 1944).

[8] 1954 IRC § 453(d)(1). This reflects prior law. Only distributions in tax-free liquidations under 1954 IRC § 332 or in which no gain or loss is recognized under 1954 IRC § 337 do not give rise to gain or loss.

[9] 1954 IRC § 311(b). Here, "inventory assets" are only stock in trade or other items which would be included in inventory. Cf. 1954 IRC § 311(c).

[10] 1954 IRC § 311(c). Where the property is taken subject to a liability (which is not assumed), the gain recognized is limited to the excess of the fair market value of the property (if less than the amount of the liability) over its adjusted basis.

4. The anticipatory assignment of income doctrine will continue to attribute income to the corporate distributor[11] under the *Horst* rationale.[12]

5. A distribution of "inventory assets" which have appreciated in value increases the distributor's earnings and profits by the amount of the increase.[13]

6. A distribution when there is a federally guaranteed or insured mortgage against property increases the corporation's earnings and profits if the amount of the loan outstanding exceeds the adjusted basis of the property (without any reduction for depreciation).[14] This increase occurs *each* time a distribution is made.

7. A distribution of stock resulting from a tax-free "spin-off, split-off, or split-up," or a nontaxable distribution of stock by a parent corporation of an existing subsidiary requires an allocation of the earnings and profits of the distributing corporation between it and the corporation whose stock was transferred,[15] under a codification of the Sansome rule.[16]

8. The Sansome rule has been further codified in tax-free intercorporate liquidations where assets acquired by the parent take the same basis which they had in the hands of the subsidiary; and in statutory reorganizations involving the acquisi-

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[11] See Sen. Rep. No. 1622, 83rd Cong., 2d Sess. 247 (1954); *Commissioner* v. *First State Bank of Stratford*, 168 F. 2d 1004 (5 Cir. 1948), cert. den. 335 U.S. 867 (1948).

[12] 311 U.S. 112 (1940).

[13] 1054 IRC § 312(b). For this purpose, "inventory assets" include not only stock in trade and other inventory items, but also property held primarily for sale to customers in the ordinary course of business, and "unrealized receivables." "Unrealized receivables" are rights to payment for goods delivered or to be delivered in the future, or for services rendered or to be rendered, whether contractural or not, to the extent that they have not been includible in income under the accounting system used by the corporation. 1954 IRC § 312(b)(2).

Rights to payment for the use of property, such as rents or royalties are not included. Since "unrealized receivables" will not have been included in income, they will have no basis. Therefore, their full fair market value will be the amount of the increase. The fair market value of accounts receivable to a cash basis corporation will increase its earnings and profits upon distribution. The value of a contract for future delivery of merchandise will have the same effect upon an accrual basis distributor.

1954 IRC § 312(c) prevents a double adjustment to earnings and profits where the distribution of inventory assets results in taxable gain. It also authorizes a further adjustment where the distributee assumes a liability or takes the property subject to a liability.

If the anticipatory assignment of income rules are to be applicable, there must be a resolution of the potential double increase in the corporation's earnings and profits: once upon distribution of the right, and second upon the realization of the income, and of the timing of the increase.

[14] 1954 IRC § 312(j). Is the excess which increases earnings and profits based upon original amount of the loan, or the amount unpaid and outstanding at each distribution? The statute suggests the latter.

Prior deficits are not to reduce the amount of each increase, but there appears to be no warrant in the statute for this conclusion. Sen. Rep. No. 1622, above, 47, 251. Comparable language in 1954 IRC § 312(b)(1) justifies a reduction. Sen. Rep. No. 1622, above, 249.

It is apparently immaterial whether the initial excess borrowings were retained or were distributed, and whether the original stockholders or new purchasers of the stock are involved.

The Treasury Department attempted, without success so far, to obtain a comparable result in *George M. Gross and Anna Gross et al.*, 23 T.C.—# 97 (1955). The distribution of the original excess borrowing over the cost of the property was not a taxable dividend where it was not "out of" earnings and profits. *See also Michael P. Erburu et al.*, 23 T.C.—# 104 (1955).

[15] 1954 IRC § 312(i) requires only that "proper adjustment" be made; Sen. Rep. No. 1622, above, 250, goes considerably further and spells out an assignment of the parent's earnings and profits to a pre-existing subsidiary if the mathematics produce an amount larger than the actual earnings and profits of the erstwhile subsidiary. If they are less, the subsidiary retains its old earnings and profits. In either event, the parent will lose a portion of its earnings and profits. See *Mandel*, 5 T.C. 684 (1945) and *Estate of McClintic*, 47 B.T.A. 188 (1942) for allocations in split-offs. Where the stock distribution is taxable, there should be no allocation of the parent's earnings and profits to the subsidiary. *Slover*, 6 T.C. 884 (1946), acq. 1946-2 C.B. 5.

[16] 60 F. 2d 931 (2 Cir. 1932), cert. den. 287 U.S. 667 (1933).

tion of substantially all the assets of another corporation for the required stock consideration or control.[17] In these cases, the earnings and profits of the transferor corporation become the earnings and profits of the acquiring corporation.[18]

9. The rule of the Phipps[19] case is modified in the types of exchanges described in paragraph 8. Any deficits existing at the time of the tax-free exchange are continued in the hands of the acquiring corporation, whether the deficit corporation is the transferor or the transferee, to be absorbed only by earnings and profits accumulated after the date of the transfer.[20]

b. Reductions in earnings and profits. Earnings and profits are reduced by the amount of money, by the face amount of obligations, and by the adjusted basis of property distributed with respect to stock,[21] thus resolving an unexpressed conflict over the amount of the reduction resulting from a dividend in kind.[22] Since a distribution of appreciated "inventory assets" increases earnings and profits by the excess of fair market value over adjusted basis, the reduction in that case is in the amount of the fair market value,[23] limited to the accumulated earnings and profits at that time.[24] Where there is an insured mortgage outstanding in excess of the cost of the property, the reduction in earnings and profits following a distribution is the full amount by which they had been increased on account of the distribution.[25]

c. Effect of distribution upon the stockholder. The amount of a distribution in kind to a noncorporate stockholder is the fair market value of the property received.[26] To a corporate stockholder, it is the fair market value of the property received, or if less, the adjusted basis of the property to the distributing corporation plus any gain recognized to it as a result of the distribution.[27] Any liabilities assumed by the stockholder, or subject to which the property is received, reduce the amount of the distribution,[28] but not below zero.

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[17] 1954 IRC § 381(a). These include statutory mergers and consolidating the acquisition of substantially all the assets of another corporation "solely" for voting stock, and the acquisition of substantially all the assets of another corporation followed by control in the acquiring corporation or its stockholders immediately after the transfer where the transferor distributes all the stock, securities, and "boot" it receives pursuant to the reorganization plan.

[18] 1954 IRC § 381(c)(2)(A).

[19] 336 U.S. 410 (1949). That rule prohibited a deficit of a transferor corporation from going over to the acquiring corporation, although it did not preclude an acquiring corporation from offsetting its deficit against the earnings and profits taken over in a nontaxable exchange. *Harter v. Helvering,* 79 F. 2d 12 (2 Cir. 1935).

[20] 1954 IRC § 381(c)(2)(B).

[21] 1954 IRC § 312(a). Nontaxable stock dividends are not "property"; taxable stock dividends are. Cf. 1954 IRC § 305(b); 1939 IRC § 115(f) with 1954 IRC § 317(a). Any liabilities accompanying the distribution decrease the reduction of earnings and profits. 1954 IRC § 312(c) and (d); 1939 IRC § 115(h).

[22] Cf. *R. D. Merrill Co.,* 4 T.C. 955 (1945); *Beach Petroleum Corp., Ltd.,* 5 T.C. Memo. 638 (1946); *Reynolds Spring Co.* v. *Commissioner,* 181 F. 2d 638 (6 Cir. 1950), expressly deciding the amount of reduction in earnings and profits with *National Carbon Co.,* 2 T.C. 57 (1943); *Hanan,* 3 T.C.M. 670 (1944); and *Acheson Est.,* 3 T.C.M. 1242 (1944) which assume without deciding the issue. Since the amount of a dividend in kind is its fair market value to a noncorporate stockholder, 1954 IRC § 301(b)(1)(A), the lack of correlation between the corporate earnings and profits reduction and the amount of the taxable dividend can support dividends taxable to the noncorporate stockholders in amounts in excess of its accumulated earnings and profits. *See* Sen. Rep. No. 1622, above, 248; H.R. Rep. No. 1337, 83rd Cong., 2d Sess., A94, for examples.

The IRC of 1954 abandoned the rule of 1939 IRC § 27(d) which used the fair market value of a dividend in kind, if lower than its adjusted basis, in determining the basic surtax credit. *See* 1954 IRC §§ 561(a)(1) and 562(a); 1939 IRC § 27(a) and (b).

[23] 1954 IRC § 312(b)(1)(B). Pre-existing deficits reduce the increase in earnings and profits and thus the amount taxable as a dividend.

[24] The limitation upon the reduction in earnings and profits insures that the surplus account will be only brought to zero and that it does not restore the prior deficit.

[25] 1954 IRC § 312(j). This preserves any prior deficits. The adjustment provided here is apparently based upon the theory that the increase in earnings and profits is tantamount to an increase in earnings and profits for the current taxable year. But the language of the statute does not easily admit this construction, particularly when compared with 1954 IRC § 312(b).

Distributions are taxed as dividends to the extent of the corporation's accumulated earnings and profits, or earnings and profits for the current year.[29] The balance reduces the basis of the stockholders' stock;[30] any amount in excess of such basis is treated as gain upon a sale of stock.[31]

The basis of property received as a dividend distribution is the fair market value in the case of a noncorporate stockholder.[32] The corporate stockholder takes the fair market value, or if less the adjusted basis to the distributing corporation plus any gain recognized to it upon the distribution.[33]

These rules apply even though no part of the distribution is taxable as a dividend because of the nonexistence of corporate earnings and profits.[34]

The taxability of distribution of property appreciated in value, appears to be resolved in favor of the decisions reached by the Tax Court in *Estate of Ida S. Godley*[35] and *Fannie Hirshon Trust*[36] (although they were later reversed),[37] that the amount of the fair market value of a property distribution was a taxable dividend only to the extent that there were actual earnings and profits.[38]

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[26] 1954 IRC § 301(b)(1)(A). Presumably, "other property" includes obligation of the distributing corporation, 1954 IRC § 317(a), although the amount of the reduction in earnings and profits is the "principal" (or face) amount of such obligations. 1954 IRC § 312(a)(2).

[27] 1954 IRC § 301(b)(1)(B).

[28] 1954 IRC § 301(b)(2).

[29] 1954 IRC §§ 301(a), 301(c)(1), 316(a); 1939 IRC §§ 22(e), 115(j), 116(a) and (b).

[30] 1954 IRC § 301(c)(2).

[31] 1954 IRC § 301(c)(3). The capital gain or ordinary income depending upon the character of the stock in the hands of the stockholder, and long- or short-term gain depending upon the holding period of the stock.

[32] 1954 IRC § 301(d)(1).

[33] 1954 IRC § 301(d)(2). Gain will result under 1954 IRC § 311(b) and (c) if the property distributed is LIFO inventory or property accompanied by a liability in excess of its basis, and under 1954 IRC § 453(d); 1939 IRC § 44(d) if the property is an installment obligation. Basis is not affected by any Liability assumed in connection with the distribution, or subject to which the property was received. Correlation is not maintained as to the amount of gain taxed to the distributing corporation, the amount of the distribution in the hands of the noncorporate stockholder, and the basis of the property in his hands. Correlation does obtain, however, where there is a corporate stockholder, except where property is received subject to a liability in excess of the fair market value of the asset. The change in valuation of dividends in kind to corporate stockholders eliminates the dividends received credit problems of 1939 IRC § 26(b).

[34] Sen. Rep. No. 1622, above, 234.

[35] 19 T.C. 1082 (1953).

[36] 12 T.C.M. 364 (1953).

[37] 213 F. 2d 529 (3 Cir. 1954); 213 F. 2d 523 (2 Cir. 1954), cert. den. Oct. 25, 1954.

[38] If property which cost the corporation $50, has a fair market value of $100 at the time of distribution when the corporation's earnings and profits are $75, the amount of the distribution taxable as a dividend is $75. The remaining $25 reduces the stockholders' basis for their stock. The House of Representatives drafted H.R. 8300 on this basis (§§ 301(b)(1) and 312(a)) and its Report specifically illustrated it. H.R. Rep. No. 1337, above, A94. When H.R. 8300 was under consideration in the Senate, the Second and Third Circuits both reversed the decisions in the Godley and Hirshon cases. *See* footnote 37, above. They held that since there were adequate corporate earnings and profits to support a dividend in some amount, a dividend occurred taxable to the extent of the full fair market value of the property even though this value exceeded the amount of the corporate earnings and profits. 1939 IRC § 115(j).

d. Stock dividends. New rules respecting stock dividends have eliminated existing "proportionate interest" tests.[39] Section 305 of the 1954 Code makes all stock dividends (or stock rights) nontaxable, whether they are common on common,[40] common on preferred,[41] preferred on common,[42] or preferred on preferred.[43] A stock dividend continues to be taxable if the stockholder has the election to take stock or money or other property.[44] And a stock dividend in payment of the current or the preceding year's dividends on preferred stock is taxable.[45]

Allocation of the basis of the old stock between it and the new stock or stock rights dividend received is still required.[46] Where nontaxable stock rights are received, however, no allocation need be made (unless the stockholder elects to do so) where the fair market value of the rights received is less than fifteen per cent of the fair market value of the old stock at the time of the distribution.[47]

e. Preferred stock bail-outs. To forestall future cases like the *Chamberlin* case,[48] section 306 creates a class of "section 306 stock" whose disposition may give rise to ordinary income rather than capital gain.[49] In the Chamberlin case, a corporation had distributed a preferred stock dividend, which, pursuant to prior negotiation, was sold by the stockholders to an insurance company. The Sixth Circuit sustained the taxpayer's position that the sale resulted in capital gain, and that the distribution was not taxable as a dividend as the Treasury Department contended.

"Section 306 stock" includes (1) *all* tax-free stock dividends (other than common on common), (2) preferred stock received in nontaxable statutory reorganizations or tax-free distributions of stock of controlled subsidiaries to the extent that such stock is substantially the same as a stock dividend[50] or was received in exchange for section 306 stock previously held, and (3) preferred or common stock (other than common stock of the original distributing corporation or its successor)

The Senate, however, continued the statutory approach adopted by the House, and 1954 IRC §§ 301 and 316 as enacted reflect a rule uninfluenced by the Circuit Court reversals. The Senate Finance Committee Report (Sen. Rep. No. 1622, above, 248) likewise illustrates the rule it intends. If a contrary conclusion were meant, there would be no necessity for 1954 IRC § 312(b) to increase earnings and profits upon a distribution of appreciated "inventory assets." It is contemplated that the Treasury Regulations will hold otherwise.

[39] See *Helvering* v. *Sprouse,* 318 U.S. 604 (1943); *Koshland* v. *Helvering* 298 U.S. 441 (1936); *Tourtelot* v. *Commissioner,* 189 F. 2d 167 (7 Cir. 1951); *Wiegand* v. *Commissioner,* 194 F. 2d 479 (3 Cir. 1952). Cf. *Schmitt* v. *Commissioner,* 208 F. 2d 819 (3 Cir. 1954).

[40] *Eisner* v. *Macomber,* 252 U.S. 189 (1920).

[41] *Koshland* v. *Helvering,* 298 U.S. 441 (1936).

[42] *Helvering* v. *Gowran,* 302 U.S. 238 (1937).

[43] *John A. Messer, Sr.,* 20 T.C. 264 (1953).

[44] Cf. *U.S.* v. *Kirby Lumber Co.,* 284 U.S. 1 (1931); *Bacon-McMillan Veneer Co.,* 20 B.T.A. 556 (1930); *Callanan Road Improvement Co.,* 12 B.T.A. 1109 (1928); 1954 IRC § 305(b)(2); 1939 IRC § 115(f)(2).

[45] 1954 IRC § 305(b)(1); 1939 IRC § 115(f)(2).

[46] 1954 IRC § 307(a); 1939 IRC § 113(a)(19) and (23).

[47] 1954 IRC § 307(b); 1939 IRC § 113(a)(19).

[48] 207 F. 2d 462 (6 Cir. 1953), rev'g 18 T.C. 164 (1952), cert. den. 387 U.S. 918 (1954).

[49] The House attempted to solve this problem by imposing upon the distributing corporation a transfer tax upon certain "nonparticipating stock" redemptions, H.R. 8300 § 309 (1954), but this approach was abandoned.

[50] As for example, preferred stock received together with common under 1954 IRC § 354; 1939 IRC § 112(b), as the result of a statutory merger, or in a newly "spun-off" company under 1954 IRC § 355; 1939 IRC § 112(b)(3) and (11), but not under 1954 IRC § 351; 1939 IRC § 112(b)(5).

having a basis determined by reference to the basis of section 306 stock previously held by the taxpayer or any other person,[51] but only to the extent that the section 306 stock would have been a taxable dividend if money had been distributed instead of stock.[52]

When section 306 stock is subsequently redeemed by the issuing corporation or its successor, the amount paid in redemption is treated in all respects as a dividend distribution under section 301.[53] To the extent of earnings and profits on hand *at that time,* a taxable dividend results; the remainder offsets the basis of the stockholders' total stockholding, and the balance is capital gain.

If the section 306 stock is not redeemed, but is sold or otherwise disposed of to third persons, the gross amount received is taxed as ordinary income from the sale of a noncapital asset[54] to the extent that a taxable dividend would have resulted if money had been distributed equal to the fair market value of the section 306 stock at the time of its distribution. Any balance of the amount received in excess of the ordinary income plus the stock's basis is treated as capital gain from the sale of the stock.[55] No loss will be recognized.[56]

Many dispositions do not evoke the penalty treatment of section 306 stock. Gifts or donations to charity or other deductible purposes can be made without any income tax consequences.[57] If the stock passes at death, there are no income tax consequences to the decedent, and the stock loses its undesirable nature.[58]

Moreover, if (1) the stockholder sells his complete package of old stock and section 306 stock together;[59] or (2) has the package redeemed simultaneously, in a complete redemption of his interest[60] or in a complete or partial liquidation;[61] or (3) even sells or redeems his old stock and then subsequently (or simultaneously) disposes of his section 306 stock (with certain qualifications to prevent avoidance devices);[62] or (4) establishes that the dividend and the redemption or disposition did not have a principal tax avoidance purpose,[63] the stock will be treated as regular stock without the penalty consequences.[64]

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[51] As in an exchange of preferred stock for preferred stock in the same corporation under 1954 IRC § 1036; 1939 IRC § 112(b)(2); or in a transfer of "section 306" stock to a controlled corporation under 1954 IRC § 351; 1939 IRC § 112(b)(5), for common stock of that company. If "section 306 stock" is "downgraded" to common stock in the issuing corporation, the common stock is no longer "section 306 stock."

Stock rights are treated the same as stock to the extent of their fair market value at the distribution date. 1954 IRC § 306(d).

[52] 1954 IRC § 306(c)(2).

[53] 1954 IRC § 306(a)(2). Corporate stockholders will have a dividend received deduction of 85 per cent of the dividend, 1954 IRC § 243; 1939 IRC § 26(b)(1). Individual stockholders will have the $50 dividend exclusion under 1954 IRC § 116 and the 4 per cent dividend credit under 1954 IRC § 34.

[54] Taxable incidents of a dividend are not applicable.

[55] 1954 IRC § 306(a)(1)(B). If the entire amount received is taxed as ordinary income, there may be some vanishing basis, since the basis of the old stock will have been allocated between it and the "section 306 stock." However, informal advices indicate that an administrative effort will be made to prevent this. If the old stock is sold before the "section 306 stock," this may not be possible.

[56] 1954 IRC § 306(a)(1)(C).

[57] 1954 IRC § 306(b)(3). But the stock retains its tainted character.

[58] 1954 IRC § 306(b)(3). The stock has a new basis.

[59] 1954 IRC § 306(b)(1)(A).

[60] 1954 IRC § 306(b)(1)(B).

[61] 1954 IRC § 306(b)(2).

[62] 1954 IRC § 306(b)(4)(B).

Section 306 applies only to stock dividends disposed of or redeemed after June 21, 1954. Stock dividends issued in years beginning prior to January 1, 1954, or subject to the Internal Revenue Code of 1939 are not affected by these rules.[65]

f. Redemption of stock. Under the 1954 Code, stock is redeemed when it is acquired by the issuing corporation in exchange for property (other than its own stock) whether or not the acquired stock is canceled, retired, or held as treasury stock.[66]

Section 302 distinguishes between redemptions which are considered distributions in payment for stock exchanged, i.e., purchases giving rise to capital gain,[67] and redemptions which are treated as distributions subject to section 301, i.e., dividends.[68]

In determining stock ownership for section 302 redemptions, certain stock attribution rules are applicable.[69] A person owns stock owned by his spouse and children, grandchildren, and parents, but not by collateral relatives.[70] Partners and beneficiaries own their proportionate shares of stock owned by partnerships, estates, and trusts; and the partnerships, estates, and trusts own the stock owned by the partners, and beneficiaries. Stock owned by "Clifford" trusts is deemed owned by the grantor and vice versa.[71] A stockholder owning 50 per cent or more in value of a corporation's stock owns a proportionate share of the stock owned by a corporation, and the corporation owns the stock he holds.[72] An option, and a series of options, to acquire stock is considered ownership of the stock.[73]

There are four types of redemptions which are considered "payment in exchange" for stock under section 302:

1. A redemption which "is not essentially equivalent to a dividend." [74] Here, the test to be employed in interpretation "is in general that currently employed under section 115(g)(1) of the 1939 Code." The touchstone is "solely" whether the

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[63] 1954 IRC § 306(b)(4)(A).

[64] Other technical rules are provided for convertible stock, 1954 IRC § 306(e), and for changes in the terms and conditions of stock, 1954 IRC § 306(g), and for the determination of the source of the income realized, 1954 IRC § 306(f).

[65] 1954 IRC § 306(h).

[66] 1954 IRC § 317(b). Any potential difference resulting from cancellation versus retention as treasury stock is eliminated. Cf. *Keefe* v. *Cote*, 213 F. 2d 651 (1 Cir. 1954).

[67] 1954 IRC § 302(a); 1939 IRC § 115(c). Redemption of stock for property appreciated or depreciated in value will produce gain or loss to the redeeming corporation.

[68] 1954 IRC § 302(d); 1939 IRC § 115(g)(1).

[69] 1954 IRC § 318. These rules differ from comparable rules which have long been incorporated in the personal holding company and other related person provisions, both in the old and new Codes. *See* 1954 IRC §§ 267(c) and 544(a); 1939 IRC §§ 24 (b) and 503(a).

[70] 1954 IRC § 318(a)(1). The family attribution rules do not continue past the first hypothetical owner.(1954 IRC § 318(a)(4)(B).

[71] 1954 IRC § 318(a)(2)(A) and (B). Exempt employee profit-sharing and pension trusts are not included.

[72] 1954 IRC § 318(a)(2)(C). An exempt foundation or trust is not included, unless considered a corporation. But cf. 1954 IRC § 267(b)(9); 1939 IRC § 24(b), where the circular attributions respecting partnership trusts and corporations stock is, at the moment, uncertain.

[73] 1954 IRC § 318(a)(3). The option rule takes precedence over the family rule.

[74] 1954 IRC § 302(b)(1); 1939 IRC § 115(g)(1).

transactions can be characterized as a sale of stock by the stockholders to the corporation.[75]

2. A substantially disproportionate redemption of stock.[76] Immediately after the redemption, the stockholder must own less than 50 per cent of the total voting power of all classes of stock, the ratio of his total voting stock to the total outstanding voting stock at that time must be less than 80 per cent of such ratio computed immediately before the redemption, and the same ratio must also be satisfied with respect to all the common stock (both voting and nonvoting) owned by the shareholder before and after the redemption.[77]

A shareholder whose stock has been redeemed can retain an interest as an officer or director of the company. He can also, if not part of an over-all plan, reacquire shares in the company at a later date without nullifying the effect of the original redemption.

3. A complete termination of a shareholder's interest.[78] Even under the Regulations under the 1939 Code, "a cancellation or redemption by a corporation of all of the stock of a particular shareholder so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend." [79] Retention of an employee interest in a corporation following a complete redemption is now permitted. Complete redemptions of stock from a shareholder in a family-held corporation are possible by the elimination of family attribution rules[80] under certain circumstances.[81]

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[75] Sen. Rep. No. 1622, above, 234. The negative phraseology of 1954 IRC § 302(b)(1) and the substitution of "dividend" for "taxable dividend" must be contrasted with the positive language in 1939 IRC § 115(g)(1). Nevertheless all the precedents decided under 1939 IRC will be determinative under 1954 IRC.

A distribution which has the effect of a dividend will be taxed, not as a purchase of stock, but as a distribution with respect to stock. Thus, even if a corporation has no earnings and profits, a pro rata distribution among its shareholders in exchange for a pro rata exchange of their stock will be treated as a distribution under 1954 IRC § 301; 1939 IRC § 115. Sen. Rep. No. 1622, above, page 234.

A redemption can be considered "not to have the effect of a dividend," even thought it does not qualify as a substantially disproportionate, or a complete, termination of a shareholder's interest. For example, a redemption of preferred stock from a shareholder who owned no common stock, could not have the effect of a dividend if there were no arrearages.

[76] 1954 IRC § 302(b)(2); 1939 IRC § 115(g)(1).

[77] Ratios are computed by reference to value of stock, if there is more than one class. The effect of the redemption will be calculated in the aggregate with respect to a planned series of redemption, if it appears that they are part of an over-all plan of redemptions. A redemption may be substantially disproportionate for one shareholder and not for another.

[78] 1954 IRC § 302(b)(3); 1939 IRC § 115(g)(1). Cf. *Zenz* v. *Quinlivan*, 106 F. Supp. 57, (D.C. Ohio 1952), rev'd 213 F. 2d 914 (6 Cir. 1954).

[79] U.S. Treas. Regs. 118, § 39.115(g)-1(a)(2) (1953).

[80] 1954 IRC § 318(a)(1).

[81] Family ownership of stock will not be attributed to a stockholder where stock is redeemed of:

a. Such shareholder surrenders all interest in the corporation, including an interest as an officer, director, or employee; he may retain a creditor interest.

b. No interest in the company can be reacquired within ten years, except by bequest or inheritance.

c. The stockholder must agree to keep necessary records and notify the Treasury of any reacquisition of a corporate interest.

d. The stock redeemed must not have been acquired within ten years prior to the redemption from anyone with whom a constructive stock ownership relationship would exist under 1954 IRC § 318(a) at the time of the redemption.

4. Redemption of stock of a railroad corporation pursuant to a reorganization plan under section 77 of the Bankruptcy Act.[82]

g. Redemptions to pay death taxes. Section 303 of the 1954 Code continues generally the principles of section 115(g)(3) of the 1939 Code and permits the redemption of stock in an amount necessary to pay estate, inheritance, legacy, and succession taxes, and interest without dividend consequences, including in addition, funeral and administration expenses allowable as deductions in computing the taxable estate for estate tax purposes. These provisions apply irrespective of the date of death of the decedent, so long as the distribution is made on or after June 22, 1954 and within specified limitation periods.[83]

For these rules to apply, the stock of the corporation must be either 35 per cent of the value of the gross estate of the decedent, as under the 1939 Code, or 50 per cent of the value of the taxable estate.[84] In computing these percentages, stock of two or more corporations may be aggregated if more than 75 per cent of the value of the outstanding stock of such corporations is owned by the estate.[85]

h. Redemption of stock of related corporations. Section 304 attempts to apply the new rules relating to redemptions and dividends to purchases of stock from a person controlling[86] both the purchasing corporation and the corporation whose stock is sold.

One set of rules reflects section 115(g)(2) of the 1939 Code, which reversed the rule of the Wanamaker Trust case,[87] and provided that a purchase by a controlled subsidiary of its parent corporation's stock would be treated as a dividend to the

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e. The person whose stock is redeemed must not have transferred any stock, within ten years prior to the redemption, to any person with whom a 1954 IRC § 318(a) relationship exists at the time of the distribution unless such stock is redeemed at the same time. These two latter conditions are not applicable if the transfer "did not have as one of its principal purposes the avoidance of Federal income tax." A transfer to put income in a lower tax bracket is not to be considered an avoidance purpose. Sen. Rep. No. 1622, above, 237.

If the stockholder reacquires a corporate interest within ten years, the original redemption will be taxed as a dividend. The statute of limitation is extended one year after notification by the stockholder, and the original capital gains tax will be offset against the larger dividend tax. Sen. Rep. No. 1622, above, 236.

If the redemption does not have the effect of a dividend under 1954 IRC § 302(b)(1); 1939 IRC § 115(g)(1), or is substantially disproportionate under 1954 IRC § 302(b)(2); 1939 IRC § 115(g)(1), a corporate interest can be reacquired within ten years. See 1954 IRC § 302(b)(5); 1939 IRC § 115(g)(1).

[82] 1954 IRC § 302(b)(4); 1939 IRC § 115(g)(1).

[83] 1954 IRC § 303(b)(1).

[84] 1954 IRC § 303(b)(2)(A). Where the full marital deduction is taken, *see* 1954 IRC § 2056(a), and where there are other deductions from the gross estate, the 50 per cent test will be 25 per cent or less of the gross estate.

[85] The rules of 1954 IRC § 303; 1939 IRC § 115(g)(3), apply to stock with a substituted basis derived by reference to stock which could have been redeemed under its provisions. They are also available to "section 306 stock." *See* Sen. Rep. No. 1622, above, 239.

[86] For these purposes, control is ownership of 50 per cent or more of the voting power or 50 per cent or more of the value of the stock of the companies. The type of control can vary as between companies. All the constructive stock ownership rules of 1954 IRC § 318 are applicable, except that the attribution rules between a stockholder and his corporation are applicable even though the stockholder owns less than 50 per cent of its stock. 1954 IRC § 304(c); 1939 IRC § 115(g)(2).

[87] 178 F. 2d 10 (3 Cir. 1949) affg. 11 T.C. 365 (1948).

same extent as if the parent had purchased its own stock from a dividend received from the subsidiary.

Another set of rules attempts to reverse the rule of the Cramer case[88] which held that where a "brother" corporation bought stock of a "sister" corporation from persons who controlled both companies, the effect was a valid purchase and not a dividend.

The pattern of the new rules is to treat the purchase of stock as if it were a distribution in redemption and then to test the distribution to see whether it could be a redemption subject to section 302 [89] by reference to the issuing corporations' stock.

In the parent-subsidiary case, if the distribution does not satisfy section 302(b), the amount paid is considered to have been a dividend from the subsidiary to the parent (thus increasing its earnings and profits) and then a distribution taxed as a dividend under section 301.[90]

In the brother-sister case, if the redemption does not satisfy section 302(b), the distribution will be a dividend measured by the earnings and profits of the purchasing corporation.[91] In any event, stock bought by the purchasing corporation will be considered as a contribution to its capital retaining the same basis it had to the stockholder.[92]

Curiously, a flaw in draftsmanship turns every "brother-sister" corporate relationship into a parent-subsidiary stockholding because of the attribution rules of section 318. Unless cured, the brother-sister rules should have no effect.[93]

3. Corporation Liquidations

The rules relating to liquidations follow, with some modifications in treatment rather than in principle, the 1939 Code. Amounts distributed in liquidation are considered payments in exchange for stock surrendered.[94] The rules of section 301 relating to dividend distributions have no applicability.[95]

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[88] 20 T.C. 679 (1953).

[89] 1954 IRC § 304(b)(1). Where a subsidiary purchases its parent's stock, there can never be a complete termination of a stockholder's interest unless the subsidiary buys all of the parent's stock owned by that stockholder. A substantially disproportionate redemption will occur only if the 1954 IRC § 318 attribution rules as applied to the percentages of stock ownership between the stockholder and the parent, and the parent and the subsidiary produce a final stockholding of less than 80 per cent of the percentage of stock owned in the parent prior to the purchase.

Where the purchase of stock is by a "brother" corporation, so long as the stockholder retains stock in the purchasing corporation, there can never be a complete termination of his interest in the issuing corporation. Whether there is a substantially disproportionate redemption depends upon the vagaries of 1954 IRC § 318 in the light of the stock percentages remaining.

[90] 1954 IRC § 304(b)(2)(B). The acquisition is treated as a redemption by the parent of its own stock.

[91] 1954 IRC § 304(b)(2)(A). The acquisition is treated as a redemption by the acquiring corporation.

[92] Will the stockholder increase the basis of his shares in the purchasing corporation by that amount?

[93] It may also be noted that a purchase of stock of a related corporation, which will have the effect of a taxable dividend under § 304 is easily by-passed by having the purchasing corporation buy assets of the related corporation (pursuant to a liquidation plan of that company) followed by a distribution in liquidation by the selling company. An election under IRC § 337 will effectuate a nonrecognition of gain to the selling corporation, and one capital gain to the stockholders.

a. Partial liquidations. The 1954 Code, for the first time, contains a definition of partial liquidation.[96] Each one in a series of distributions in complete liquidation is a partial liquidation. More important, a partial liquidation is a distribution which "is not essentially equivalent to a dividend," is in redemption of a part of the stock pursuant to a liquidation plan, and occurs within the taxable year of adoption of the plan, or the succeeding year.

The *sine qua non* of a partial liquidation is a "corporation contraction": [97] that of a redemption under section 302 is the effect upon the shareholder. The case of *Joseph Imler*[98] illustrates the difference. There a corporation distributed, in pro rata purchase of some of its stock, the insurance proceeds received as a result of a destruction by fire of the top two floors of its plant. Certain operations were discontinued. This type of distribution is now a partial liquidation under section 346, not a redemption under section 302.[99]

This one statutory definition of a partial liquidation is contained in section 346(b): A corporation distributes either the assets or the proceeds of the sale of a business, and continues the operation of another business. Each business was actively operated for at least five years prior to the distribution, either by the taxpayer for that period, or, if not by the taxpayer for the entire period, was acquired by the taxpayer in a *completely* taxfree exchange during those five years.[100]

b. Tax-free intercorporate liquidation. Section 332 of the 1954 Code preserves the major outlines of section 112(b)(6) of the 1939 Code which provided for the nonrecognition of gain or loss upon certain intercorporate liquidations.[101] These changes have been made: So long as the requisite stock ownership exists at the date of adoption of the plan of liquidation and at all times until the receipt of the property, it is immaterial whether the parent's stock ownership fluctuates upward or downward in the interim.[102]

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[94] 1954 IRC § 331(a); 1939 IRC § 115(c). Part II of Subchapter C applies to liquidation plans only if the first distribution occurs after June 21, 1954. 1954 IRC § 392(a). There are special rules applicable to 1954 IRC § 337 for the year 1954 and for liquidation plans adopted prior to June 22, 1954. 1954 IRC § 392(b).

[95] 1954 IRC § 331(b). 1954 IRC §§ 311(b) and 311(c) creating taxable gain to a corporation distributing certain LIFO inventory and property with a liability in excess of its basis do not apply to a liquidating corporation. Cf. H.R. 8300 § 308(d); H.R. Rep. 1337, above, A91. As under the 1939 Code, there is gain to a corporation distributing installment obligations in liquidations. 1954 IRC § 453(d)(1); 1939 IRC § 44(a), except in certain nontaxable liquidations, 1954 IRC § 453(d)(4); 1939 IRC § 44(d).

[96] 1954 IRC § 346.

[97] Sen. Rep. No. 1622, above, 49,262. The definition of a "redemption" in 1954 IRC § 317(b) is not specifically applicable to liquidations.

[98] 11 T.C. 836 (1948); *see* footnote 97, above.

[99] Distributions may qualify both as redemption under 1954 IRC § 302; 1939 IRC § 115(c) and as partial liquidations under 1954 IRC § 346. If so, the partial liquidation rules govern. 1954 IRC § 346(c). They contain no sanction against the stockholder retaining or reacquiring a corporate interest. The stock attribution rules of 1954 IRC § 318 are not applicable. And it is immaterial whether or not a partial liquidation distribution is pro rata.

Qualification under 1954 IRC § 302 is not considered in determining qualification under 1954 IRC § 346. Any portion of a distribution which does not satisfy 1954 IRC § 346 will be governed by 1954 IRC §§ 302 and 301. Sen. Rep. No. 1622, above, 233.

[100] 1954 IRC § 346(b). There are at least three particularly difficult problem areas here: (1) What is a separate trade or business? (2) what is meant by "active conduct"? and (3) what is the scope of a completely tax-free exchange; e.g. does it include purchases of a business in which no gain or loss is recognized to the selling corporation under 1954 IRC § 337?

[101] These are liquidations where the parent corporation owns at least 80 per cent of the combined voting power of all classes of voting stock and of the total number of shares of all other classes of nonvoting stock, except preferred stock.

Section 332(c) provides for the nonrecognition of gain or loss to the subsidiary if it satisfies an obligation to the parent with property during a tax-free intercorporate liquidation.[103]

The basis of the property of the subsidiary received by the parent is the same as it was in the hands of the subsidiary, whether the property is received with respect to an obligation or stock of the subsidiary.[104]

c. One-month liquidations. Section 333 of the 1954 Code makes permanent the rules of section 112(b)(7) of the 1939 Code, and provides that the liquidation of a corporation within one calendar month, pursuant to a plan adopted on or after June 22, 1954, will generally be tax free.[105] However, any portion of the potential gain which does not exceed a noncorporate stockholder's share of the accumulated earnings and profits, is taxed as a dividend,[106] and any remainder of the potential gain is taxed as capital gain to the extent of the money, or of the stock or securities acquired by the corporation after December 31, 1953. In the case of the corporate stockholder, the greater of the above two is taxed as capital gain.[107]

Section 333 does not extend to collapsible corporations to which section 341(a) of the 1954 Code applies.[108]

The basis of the property received in a one-month liquidation is equal to the basis of the stock cancelled minus any money received, plus any gain recognized (whether as a dividend or as capital gain) plus any liabilities either assumed by the electing shareholder or to which the property acquired was subject.[109] If the corporation uses property appreciated or depreciated in value to satisfy an obligation to the stockholder, it will have taxable gain or loss. The stockholder's basis will, of course, be fair market value.

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[102] Under 1939 IRC § 112(b)(6), a liquidation was taxable if the parent owned more stock of the subsidiary at the time of adoption of plan of liquidation than at the time of receipt of the property.

[103] Under the 1939 Code, a subsidiary which used property appreciated in value to pay a liability to its parent in the liquidation, realized a taxable gain on the appreciation, I.R. 4109, 1952-2 C.B. 138, unless it entered into a closing agreement deferring the recognition of such gain. Rev. Rul. 259, 1953-2 C.B. 55. The parent, however, will still have gain to the extent payment exceeds its basis for the obligation. Sen. Rep. No. 1622, above, 256; *Houston Natural Gas Corp.* v. *Commissioner*, 173 F. 2d 461 (5 Cir. 1940).

[104] 1954 IRC § 334(b)(1); 1939 IRC § 113(a)(15).

[105] One month liquidations pursuant to plans adopted between January 1, 1954 and June 22, 1954 cannot qualify. Cf. Technical Changes Act of 1953, § 101.

[106] Do the provisions of 1954 IRC §§ 312(b) and 312(j) which increase earnings and profits upon a distribution "with respect to stock" of "inventory assets" appreciated in value, or when there is an insured mortgage outstanding in excess of the cost of the property, apply to a one-month liquidation for the purpose of increasing earnings and profits which may convert potential unrecognized gain into a taxable dividend? Since a liquidation is a payment "in exchange for the stock" and not a "distribution with respect to its stock," it is not believed that any earnings and profits are created by the liquidation. Cf. *Hanan*, 3 T.C. Memo. 670 (1944), app. dism. (2 and 3 Cirs., Aug. 9, 1945).

Do the provisions of 1954 IRC § 311(b) and 311(c), which create taxable income to a corporation upon the distribution of certain LIFO inventory and property with a liability in excess of basis, apply in 1954 IRC § 333; 1939 IRC § 112(b)(7) liquidation? It is believed not.

[107] A stockholder corporation owning 50 per cent or more of the voting power of stock entitled to vote on the adoption of this type of liquidation plan at any time between January 1, 1954 and the adoption of the plan, is excluded from these rules. The benefits of 1954 IRC § 333; 1939 IRC § 112(b)(7) are available only if, subject to conditions carried over from the old law, qualified electing shareholders so elect within thirty days after the adoption of the plan of liquidation.

[108] Informal rulings under the 1939 Code indicated that the 1939 IRC § 112(b)(7) superceded the collapsible corporation provision of IRC 1939 § 117(m).

d. The *Kimbell-Diamond* basis rule. Section 334(b)(2) of the 1954 Code codifies the rule of the Kimbell-Diamond Milling Co.[110] case for corporate stockholders only,[111] and eliminates the factor of intent to purchase assets. Now, the cost of stock of a corporation becomes the basis of its assets taken over in liquidation by its parent corporation under the following circumstances:

1. Stock bearing 80 per cent or more of the total combined voting power *and* 80 per cent or more of all other nonvoting shares (not including preferred stock) must be purchased[112] within a 12-month period.
2. The liquidating distributions must be under a plan adopted on or after June 22, 1954, and within 2 years from the acquisition of the requisite 80 per cent stock ownership.[113]
3. The liquidation must satisfy the provisions of section 332.

If these conditions are satisfied, the basis of the assets taken over in liquidation of the subsidiary is equal to the cost of its stock, plus any liabilities assumed or to which the property is taken subject, minus any dividends which have been paid by the subsidiary prior to the adoption of the liquidation plan (whether before or after the accumulation of the crucial 80 per cent of stock), plus or minus any other proper adjustments which are necessary to correlate the purchase of the stock with the idea that, in effect, assets were purchased at that time.[114]

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[109] 1954 IRC § 334(c); 1939 IRC § 113(a)(18). *See also* Rev. Rul. 95, 1953-1 C.B. 162. *See* 1954 IRC § 453(d)(4)(B); 1939 IRC § 44(d) as to installment obligations.

[110] 187 F. 2d 718 (5 Cir. 1951) cert. den. 342 U.S. 827 (1951), affg. 14 T.C. 74 (1950); cf. *Kanawha Gas & Utilities Co.* v. *Commissioner*, 214 F. 2d 685 (5 Cir. 1954) where the filing of a consolidated return with subsidiaries did not debar the parent from applying the cost of their stock to their assets taken over in liquidation since the intent was to acquire assets; *Texas Bank and Trust Co. of Dallas*, 12 T.C.M. 588 (1953); but cf. *Distributor's Finance Corp.*, 20 T.C. 768 (1953), pp. dism. (9 Cir. 1954).

[111] In *Snively*, 19 T.C. 850 (1953), commissioner's appeal withdrawn (5 Cir. 1954); an individual bought stock of a corporation with the intent to acquire assets, and was authorized to take the cost of the stock as the basis of the assets taken over on liquidation. Presumably this is still good law in the absence of contrary legislation.

[112] 1954 IRC § 334(b)(3). Purchase does not include tax-free acquisitions nor acquisitions from a person who bears a constructive ownership relationship to the purchaser under 1954 IRC § 318.

[113] 1954 IRC § 334(b)(2). While not elective, this section gives a two-year period of time for a corporation to decide whether to obtain a stock-cost basis for assets instead of a transferor's basis. There is no provision as to when, after the adoption of the liquidation plan, the liquidating distributions must be started. However, since the liquidation must be nontaxable under 1954 IRC § 332; 1939 IRC § 112(b)(6), the distributions, once started, must be finished within three years.

[114] For example, any profits or losses realized by the subsidiary (subsequent to the acquisition of 80 per cent of its stock) from the sale of assets at a price in excess of their basis recomputed to accord with the cost of its stock, should be a plus or minus adjustment to the cost of the stock. Cf. IRC 1939 §§ 472 and 761 and U.S. Treas. Regs. 130, § 40.472-4 and 5 (1951) and Regs. 112, § 35.761-4 and 5 (1944) for a similar pattern of adjustments in computing invested capital credits for excess profits tax purposes.

e. The Anti-Court Holding Co. rule. Between the different mechanics of sale of corporate assets, as illustrated in the *Court Holding Co.*[115] case and in the *Cumberland Public Service Co.*[116] decision, lay a tax trap.[117]

To prevent the innocent or the uninformed from being penalized, section 337 of the 1954 Code is designed to produce only one tax on a corporate sale of assets followed by liquidation. Under its rules, if: (1) a corporation adopts a plan of liquidation on or after June 22, 1954, and (2) distributes all of its assets in complete liquidation within 12 months after the adoption of the plan, then (3) no gain or loss realized will be recognized to the corporation from the sale of property within this 12-month period.[118]

Despite these provisions, gain will be recognized in the case of the sale of stock in trade, inventory items, or property held primarily for sale to customers in the ordinary course of business both before and after the adoption of the liquidation plan; and of installment obligations received in connection with the sale of such assets, whether the sale occurred before or after the adoption of the liquidation plan; and of installment obligations acquired upon the sale of noninventory assets *after* the liquidation plan has been adopted.[119] However, a "bulk sale" of substantially all the inventory assets of one or more of the trades or businesses operated by the corporation, to one person in one transaction, and of installments obligations acquired upon such a bulk sale, will be subject to the nonrecognition rules.

Section 337 does not apply to any sales or exchanges made by a collapsible corporation.[120] Nor do they apply if the liquidation following the sale is nontaxable (whether in whole or in part) under the one-month liquidation provisions of section 333, or is nontaxable under the intercorporate liquidation rules of section 332.[121] If, however, the basis of the property taken over in the intercorporate liquidation is determined according to the Kimbell-Diamond rules of section 334(b)(2), then only that portion of the gain realized by the selling company which exceeds the basis of the assets sold, revalued to accord with the cost of its stock, will be taxed.[122]

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[115] 324 U.S. 331 (1945).

[116] 338 U.S. 451 (1950).

[117] Sale, or negotiation for sale, by or on behalf of the corporation followed by liquidation of the assets or the proceeds involved produced two taxes: one to the corporation upon the sale and the second to the stockholders upon liquidation. Liquidation of the corporation followed by sale of the assets received by the stockholders resulted in one tax to the stockholders upon liquidation. *See Dallas Downtown Development Co.*, 12 T.C. 114 (1949), acq. 1950-1 C.B. 2.

[118] While the rules are not elective, the requirements which must be satisfied provide effective elections for the use or non-use of these provisions. If 1954 IRC § 337 is applicable, the benefits of a loss on the sale of assets cannot be utilized either against current operating profits, or as part of net operating loss carry-back.

Elective applicability provisions of 1954 IRC § 392(b) extend the same treatment to sales and liquidations completed during 1954 irrespective of any liquidation plans, and also to liquidations within 12 months after plans adopted between January 1, 1954 and June 22, 1954.

[119] 1954 IRC § 337(b).

[120] 1954 IRC § 337(c)(1)(A). Collapsible corporations, *as defined* in 1954 IRC § 341(b); 1939 IRC § 117(m)(2) and (3) are excluded although 1954 IRC § 341(a); 1939 IRC § 117(m)(1) might not apply to transform capital gain into ordinary income.

[121] 1954 IRC § 337(c)(1)(B) and § 337(c)(2)(A).

[122] 1954 IRC § 337(c)(2)(B). The result reached is the same as if the subsidiary had first been liquidated, the basis of its assets recomputed to take the cost of its purchased stock, and the sale made then.

f. Collapsible corporations. Corporations formed or availed of to enable their stockholders to realize gain attributable to corporate property, at capital gain rates, before the corporation realizes a substantial part of the taxable income attributable to such property, are "collapsible" corporations under section 341 of the 1954 Code. Long-term gain from the sale or exchange of stock of such a corporation is metamorphosed into ordinary income. Short-term capital gain remains such.[123]

Property which may make a corporation collapsible is defined as a "section 341 asset." [124] In addition to inventory items,[125] there is included depreciable property used in the trade or business, whether held for six months or less, which is not used for the manufacture, construction, production, or sale of stock in trade, inventory items, or goods held primarily for sale.[126] There are also included "unrealized receivables" which are rights to payment for goods or services, delivered or rendered, or to be delivered or rendered, which have not been included in income,[127] but not from the sale of capital assets or nonsection 341 assets. All these assets must be held less than three years.[128]

If, at the time of the realization of gain on the stock, the fair market value of the "section 341 assets" is 50 per cent or more of the fair market value of all the corporate assets, and 120 per cent or more of their adjusted basis, the corporation is presumed to be a collapsible corporation, unless shown to the contrary.[129] Under the 1954 Code, the collapsible rules apply to a stockholder owing 5 per cent or more in value of the stock of the corporation at any time after the completion of the acquisition of the "section 341 assets." [130] The other escape provisions, the 70 per cent gain rule[131] and the three-year holding period[132] are the same as the 1939 Code.

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[123] 1954 IRC § 341(a); 1939 IRC § 117(m)(1). As under the 1939 Code, the gain affected occurs upon the sale or exchange of stock, including exchanges in partial or complete liquidation of the corporation. Codifying the earlier regulations, U.S. Treas. Regs. 118, § 39.117(m)-1(a)(3) (1953), 1954 IRC§ 341 (a) also includes gain upon the receipt of a corporate distribution which, under 1954 IRC § 301(c)(3)(A), is treated as gain from a sale of stock in an amount in excess of the basis of the stock. These rules apply after June 21, 1954.

[124] 1954 IRC § 341(b)(3); 1939 IRC § 117(m)(2) and (3).

[125] Stock in trade, inventory items, and goods held primarily for sale to customers in the ordinary course of business.

[126] This type of asset is defined in 1954 IRC § 1231(b); 1939 IRC § 117(j)(1). The same property owned by a manufacturing business and used as its plant, would not be a "section 341 asset."

[127] These are the same kinds of assets which will increase a corporation's earnings and profits, under 1954 IRC § 312(b), if they are distributed as a dividend.

[128] For this purpose, the holding period provisions of 1954 IRC § 1223; 1939 IRC § 117(h) which "tack on" the holding period of a transferor in a nontaxable transfer are applicable. Thus, if an individual who owned real property for two years transfers it to a corporation in a nontaxable exchange, and sells his stock after one year from the date of the transfer, the corporation will be deemed to have held the property for longer than three years, and any gain to the individual will be long-term capital gain. However, the three-year period runs from the date of completion of the manufacture, construction, production, or purchase of the property. And so if the property transferred were in the construction stage, the "tacking on" provisions would not be applicable, and the corporation would have to hold the property for three years following the date of completion.

[129] For these purposes, total assets do not include cash, stock owned in any other corporation, and certain governmental short-term discount obligations issued on or after March 1, 1941. They do, however, include goodwill and other intangibles which may not be entered on the books but which do have an ascertainable fair market value.

[130] 1954 IRC § 341(d)(1). Under the 1939 Code, there had to be 10 per cent or more stock ownership; 1939 IRC § 117(m)(3)(A).

A major problem arising under the 1954 Code is whether the collapsible provisions have any further force and effect. Section 337 permits a corporation to sell property after the adoption of a liquidation plan, and to distribute the proceeds to its stockholders in complete liquidation without incurring any tax liability. Although it does not apply to collapsible corporations, as defined in section 341(b), where the corporate property is sold, a substantial part of the income (if not all) attributable to the property has been *realized*, and the corporation should no longer be a collapsible under section 341(b).[133]

4. Corporate Organizations and Reorganizations

a. Transfer to controlled corporation. Section 351 of the 1954 Code provides that if one or more persons transfer property to a corporation for its stock and securities,[134] and immediately after the transfer such persons are in control[135] of the corporation, the transfer is a nontaxable exchange. Section 112(b)(5) of the 1939 Code is thus continued with these important exceptions:

The proportionate interest test is eliminated. This may cause more difficulties than it solves. While preserving the nontaxable character of the transfer to a controlled corporation to be taxable, it merely shifts tax consequences to the stockholder level. "In any case in which the stock and securities received are not in proportion, the transaction will be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts, to pay compensation, or to satisfy obligations of any kind."[136]

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[131] 1954 IRC § 341(d)(2); 1939 IRC § 117(m)(3)(B).

[132] 1954 IRC § 341(d)(3); 1939 IRC § 117(m)(3)(C).

[133] 1954 IRC § 341(b); 1939 IRC § 117(m)(2) and (3) applies only if the stockholders realize gain before "the realization by the corporation . . . of a substantial part of the taxable income to be derived from such property." The fact that "no gain or loss shall be *recognized* to such corporation from the sale or exchange by it of property," under 1954 IRC § 337 does not destroy the fact that there has been *realization* of income. The profit on the sale of property is just as much income derived from the property as is the accumulation of current operating profit. Nor do the words "taxable income" have any significance. In 1939 IRC § 117(m)(2)(A)(i) the corresponding words were "net income." For this purpose, "taxable income" in the 1954 Code is synonymous with "net income" in the 1939 Code. There are no implications that income must be *recognized* for tax purposes, merely because the statutory definition of gross income minus deductions is "taxable income" rather than "net income." Cf. 1954 IRC §§ 61, 63 with 1939 IRC §§ 21, 22.

[134] Part III of Subchapter C relating to corporate organizations and reorganizations takes effect on June 22, 1954.

"Securities" are not defined in the 1954 Code, and the precedents under the 1939 Code, which regarded, generally, relatively long-term evidences of debt, such as five-year notes, as "securities" will be still pertinent. *See Camp Wolters Enterprises, Inc.*, 22 T.C. No. 194 (1954).

[135] "Control" here, as in the reorganization provisions as well, is defined (as under the 1939 Code) as 80 per cent or more of the voting power of stock, and 80 per cent of all other shares of stock. 1954 IRC § 368(c); 1939 IRC § 112(h).

[136] Sen. Rep. No. 1622, above, 264, 265. "To the extent, however that the existing disproportion between the value of the property transferred and the amount of stock and securities received by each of the transferors results in an event taxable under other provisions of this Code, your Committee intends that such distribution will be taxed in accordance with its true

Services(past or present) are not property.[137] Thus, a person who receives stock, in what would otherwise be a section 351 exchange, for his services to be rendered to the corporation will be deemed to receive taxable compensation.[138] If he gets more than 20 per cent of the stock of the company, unless he also conveys property, the entire transaction will be taxable since the persons transferring property will not be in control of the corporation.

If the transferee corporation transfers "boot": money and other property, in addition to stock and securities, gain will be recognized to the transferors, but in an amount not in excess of the "boot" received. A loss is never recognized.[139]

If the transferor is a corporation, it can distribute to its shareholders and securityholders the stock and securities received without affecting the tax-free nature of the section 351 transfer. It is immaterial whether this distribution is in the form of a taxable dividend, a nontaxable dividend, a redemption, a partial liquidation, or a complete liquidation.[140] However, a distribution of "boot" to the transferor's stockholders will not relieve the transferor of taxable gain.[141]

b. Reorganizations. The same types of transfers and exchanges which constituted reorganizations under section 112(g) of the 1939 Code are continued in section 368 of the 1954 Code:

1. *Statutory mergers and consolidations.*[142] The rule of the Groman[143] and Bashford [144] cases is modified, so that the emerging corportion can transfer all or a part of the assets acquired to a controlled subsidiary as part of the reorganization without destroying its potential tax-free aspects.[145]

2. *The acquisition by a corporation, solely for its voting stock, of stock of another corporation with the acquiring corporation in control of the other corporation immediately thereafter.*[146] It is immaterial whether the acquiring corporation previously owned some stock of the other corporation, whether this prior stock was acquired for voting stock, or nonvoting stock, or for cash or other property, and whether such prior ownership constituted control or less than control.[147] Furthermore, the acquisition may be by "creeping control," obtained in a series of transactions extending over a "relatively short period" of time such as less than twelve months.[148]

3. *The acquisition by a corporation "solely" for its, or its controlling parents', vot-*

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nature." H.R. Rep. No. 1337, above, A117; Sen. Rep. No. 1622, above, 264.

Where there is taxable income to one stockholder receiving a disproportionate stock interest, there may be an ordinary deduction to the other shareholder plus a capital gain or loss if the stock used to discharge an obligation has a fair market value different from its adjusted basis.

It is not necessary that all the transferors of property receive stock or securities in exchange, or that all receive both stock and securities. Some can get stock, and some securities, or some nothing at all, so far as the taxability of the transfer to the corporation is concerned.

[137] 1954 IRC § 351(a); 1939 IRC § 112(b)(5).

[138] H.R. Rep. No. 1337, above, A117.

[139] 1954 IRC § 351(b); 1939 IRC § 112(c) and (e).

[140] 1954 IRC § 351(c); 1939 IRC § 112(b)(5); Sen. Rep. No. 1622, above, 265.

[141] Unless the transfer is also a statutory reorganization, *see* 1954 IRC § 361(b)(1)(A); 1939 IRC § 112(d) and (e).

[142] 1954 IRC § 368(a)(1)(A); 1939 IRC § 112(g)(1).

[143] 302 U.S. 82 (1937).

[144] 302 U.S. 454 (1938).

[145] 1954 IRC § 368(a)(2)(C); 1939 IRC § 112(g)(1).

[146] 1954 IRC § 368(a)(1)(B); 1939 IRC § 112(g)(1).

[147] Under the 1939 Code, the decisions were divided upon this point.

[148] Sen. Rep. No. 1622, above, 273.

ing stock of substantially all the properties of another corporation.[149] In addition to voting stock, "boot" up to 20 per cent of the value of *all* the property of the acquired corporation can be paid without converting the entire transfer into a taxable exchange.[150] In such case, the amount of liabilities assumed or subject to which property is received (which are otherwise not taken into account) will be added to the "boot" in computing the 20 per cent test. Here, also, the *Groman* and *Bashford* rules are reversed.[151]

4. A *transfer by a corporation of all or part of its assets to another corporation if the transferor or one or more of its shareholders is in control of the transferee corporation immediately after the transfer.*[152] The transferor *must* distribute to its shareholders all the stock and securities it received from the transferee corporation in a nontaxable exchange or distribution to such shareholders.[153]

5. *Recapitalizations,*[154] *and mere changes in identity, form, or place of organization*[155] *are also continued as reorganizations.*

Transfers of property by a corporation pursuant to a statutory reorganization are tax free.[156] If "boot" is received by the transferor corporation, gain is recognized but not in excess of the amount of the "boot." [157] No loss is ever recognized.[158] If the "boot" is distributed to its shareholders, however, no gain is recognized to the transferor.[159]

c. Basis. The rules relating to basis are substantially the same as under the 1939 Code. The acquiring corporation takes the property with the same basis as it had in the hands of the transferor, increased by any gain to the transferor.[160] The basis of stock and securities received by the transferors is the same as the basis of the property they transferred, decreased by any money and the fair market value of any other property received as "boot," and increased by the amount of any gain recognized to them. Property received as "boot" takes fair market value as its basis.[161]

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[149] 1954 IRC § 368(a)(1)(C); 1939 IRC § 112(g)(1).

[150] 1954 IRC § 368(a)(2)(B); 1939 IRC § 112(g)(1).

[151] *See* footnote 145, above. The controlling parent corporation of the acquiring corporation can transfer its voting stock in exchange for the assets transferred to the acquiring corporation, or the acquiring corporation can convey all or part of the assets it acquired in one of these exchanges to a controlled subsidiary, as part of the reorganization plan.

[152] 1954 IRC § 368(a)(1)(D); 1939 IRC § 112(g)(1).

[153] If the stock and securities are not distributed to the transferor's shareholders, the transfer will not be a "reorganization," but it may be nontaxable under 1954 IRC § 351; 1939 IRC § 112(b)(5).

This definition is designed to cover the so-called divisive reorganizations, such as spin-offs, split-offs, and split-ups. If a transfer satisfies both the "C" definition, that is an asset acquisition solely for voting stock, and also the "D" type, the transfer of property followed by control, the rules applicable to the "D" reorganizations are applied. 1954 IRC § 368(a)(2)(A); 1939 IRC § 112(g)(1).

[154] 1954 IRC § 368(a)(1)(E); 1939 IRC § 112(g)(1).

[155] 1954 IRC § 368(a)(1)(F); 1939 IRC § 112(g)(1).

[156] 1954 IRC § 361(a); 1939 IRC § 112(b)(4). These rules are the same as the 1939 Code.

[157] 1954 IRC § 361(b)(1)(B); 1939 IRC § 112(d).

[158] 1954 IRC § 361(b)(2); 1939 IRC § 112(e).

[159] 1954 IRC § 361(b)(1)(A); 1939 IRC § 112(d).

[160] 1954 IRC § 362; 1939 IRC § 113(a)(7) and (8). This applied both in 1954 IRC § 351 transfers and in reorganizations.

[161] 1954 IRC § 358; 1939 IRC § 113(a)(6). These rules apply both to 1954 IRC § 351; 1939 IRC § 112(b)(5) transfers and to reorganizations, and also to the "divisive" exchanges governed by 1954 IRC § 355; 1939 IRC § 112(b)(3) and (11), to be discussed below.

If a nonstockholder makes a property contribution to the capital of a corporation on or after June 22, 1954, a new rule makes the basis of such property zero.[162] If money is contributed, the basis of any property bought with such money within 12 months following the contribution is reduced by the amount of the contribution. Any excess is to be used to reduce the basis of other property held by the corporation, under regulations to be promulgated.[163]

d. Assumption of liability. Section 357 of the 1954 Code continues the rule that the assumption of liability, or the taking of property subject to a liability, except for a tax-avoidance purpose or for a non-bona fide business purpose,[164] in a section 351 exchange or in a reorganization, shall not be considered as "boot."

However, section 357(c) provides that where property is transferred and a liability is either assumed by the transferee, or is a lien against property acquired, in excess of its adjusted basis, taxable gain is recognized to the transferor measured by the excess of the liability over the basis.[165]

e. Stockholders in reorganizations. As under the 1939 Code, no gain or loss is recognized when a stockholder exchanges stock in one corporation which is a party to a reorganization for stock in another corporation which is a party to such reorganization.[166]

But new rules are provided where securities are involved. Under section 354(a)(2) of the 1954 Code, securities may be received by a stockholder in a reorganization completely tax free *only* if he surrenders securities in a principal amount equal to, or greater than, the principal amount of the securities received. If the principal amount received is greater than the principal amount surrendered, the fair market value of the excess is "boot," and may be taxed.[167] Thus, bond for bond recapitalizations may no longer be completely tax free.[168]

f. Stockholders in divisive reorganizations. Section 355 of the 1954 Code provides the mechanism for nontaxable distributions of stock and securities of a controlled corporation.

Under the 1939 Code, the distribution of stock of an existing subsidiary was treated as a taxable dividend.[169] It could only be "spun-off" [170] if its stock were first transferred to a newly formed holding company for a good business reason, and that stock distributed to stockholders. Now the subsidiary's stock can be distributed directly, tax free.[171] Under the 1939 Code, there could be no "spin-off" of preferred stock of a newly created subsidiary. Now there can be.[172] Under the 1939 Code, the creation of a newly formed subsidiary to be spun-off had to constitute a reorganization, and be justified by a business purpose.[173] The new subsidiary can now be formed either in a reorganization or pursuant to section 351.[174]

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[162] 1954 IRC §362(c)(1). Cf. *Brown Shoe Co.* v. *Commissioner*, 339 U.S. 583 (1950).

[163] 1954 IRC § 362(c)(2).

[164] This purpose must be "the principal purpose."

[165] This gain is ordinary or capital, depending upon the character of the asset. The rule applies to all section 351 exchanges and reorganizations. Unlike the comparable rule in corporate distributions of property, 1954 IRC § 311(c), there is no ceiling on the gain if the fair market value of the property is less than the liability when the liability is not assumed.

[166] 1954 IRC § 354; 1939 IRC § 112(b)(3).

[167] Under the 1939 Code, a stockholder in a reorganization who received stock and securities in exchange for stock would have no taxable gain. Cf. *Penfield* v. *Davis*, 205 F. 2d 798 (5 Cir. 1953); *Commissioner* v. *Carmen*, 189 F. 2d 363 (2 Cir. 1951) affg. & revg. 13 T.C. 1029 (1949) acq. 1954-31 I.R.B. 6; *Seide*, 18 T.C. 502 (1952); *Shanis*, 19 T.C. 641 (1953) acq. 1954-31 I.R.B. 6.

[168] Cf. *Commissioner* v. *Neustadt's Trust*, 131 F. 2d 528 (2 Cir. 1942).

[169] Sen. Rep. No. 1622, above, 267.

[170] As under the 1939 Code, the "spin-off" type of distribution is authorized whereby the stockholders of the distributing corporation do not have to surrender any stock in that corporation. If stock is surrendered, the distribution is classified as a "split-off"; and if the distributing corporation is completely liquidated, it is a "split-up." The rules are the same for each type. *See* 1954 IRC § 355(a)(2)(B); 1939 IRC § 112(b)(11).

Under the 1939 Code, spin-offs, split-offs, and split-ups, had to be pro rata to the existing stockholders. This is no longer necessary. For example, Corporation A which operates businesses X and Y can be split-up into two new Corporations X and Y, with the stock of X distributed to one stockholder and the stock of Y to another.[175]

The 1954 Code permits the existing corporation to retain up to 20 per cent of the stock of the controlled corporation whose stock is distributed. But it must be shown that such retention of such stock and of securities is not for a tax avoidance purpose.[176]

The 1954 Code specifically permits the stockholders to sell stock received in the controlled corporation without affecting the tax-free nature of the distribution, provided that the sale was not made pursuant to negotiations or agreements prior to the distribution of the stock.[177]

As in reorganization exchanges, securities received in a controlled corporation will be received tax free only if the principal amount (face amount) of securities in the controlled corporation do not exceed the principal amount of securities of the distributing corporation surrendered by the stockholder. Any excess is "boot." [178]

The purpose underlying section 355 is to authorize corporate division without tax consequences where existing businessess are merely separated or segregated into different corporate entities, and where ownership is maintained (although not necessarily pro rata) [179] by the existing stockholders. Necessarily, the transfer cannot be utilized "principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both." [180]

Qualifying nontaxable distributions under section 355 result only if:

1. The distributing company and the controlled corporations distributed must be engaged in the active conduct of a business immediately after the distribution,[181] or

2. The distributing corporation had no assets immediately before the distribu-

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[171] Cf. 1939 IRC § 112(b)(11) with Sen. Rep. No. 1622, above, 50, 266, 267.

[172] *Ibid.* *See* Sen. Rep. No. 1622, above, 267.

[173] *See* footnote 172.

[174] 1954 IRC § 355(a)(2)(C); Sen. Rep. No. 1622, above, 266, 267. The Treasury will probably try to import "business reasons."

[175] 1954 IRC § 355(a)(2)(A); Sen. Rep. No. 1622, above, 50, 266. If not pro rata, tax consequences may result at the stockholder level.

[176] 1954 IRC § 355(a)(1)(D); retention of some stock, for example, is permissible to continue management representation upon the Board of Directors of the spun-off corporation.

[177] IRC § 355(a)(1)(B); H.R. Rep. (Conference) No. 2543, above, 37.

[178] 1954 IRC §§ 355 (a)(3), (4), 356 (d)(2)(C).

[179] Disproportionate transfers, while not converting the distribution into a taxable distribution, may produce tax consequences at the shareholder level, as in 1954 IRC § 351. 1939 IRC § 112(c) and (e). *See* Sen. Rep. No. 1622, above. 50.

[180] 1954 IRC § 355(a)(1)(B); 1939 IRC § 112(b)(11).

[181] 1954 IRC § 355 (b)(1)(A); 1939 IRC § 112(b)(11).

tion other than stock or securities of controlled corporations actively engaged in business, and they are all actively engaged in business after the distribution.[182]

3. A corporation is engaged in the active conduct of a business only if it has carried one on for five years, or only if substantially all its assets are stock and securities owned for five years in other corporations engaged in the active conduct of a business.[183]

4. The business activity need not have been carried on by the distributing corporation itself for five years. The period of operation by a predecessor is included, but *only* if the business was acquired from it in a *completely* tax-free exchange. A purchase of a business, or the acquisition in a reorganization in which *some* gain or loss was recognized starts the running of the five-year period.[184]

5. In the same manner, the acquisition of stock of a corporation in a *completely* tax-free acquisition will "tack on" the holding period of the prior owner. Otherwise, the holding period for that stock begins at the time of acquisition.[185]

g. "Boot" in distributions following reorganizations and other nontaxable exchanges. The 1954 Code lays down virtually the same rules as the 1939 Code.[186] If there is gain recognized to the extent of "boot" distributed in an exchange with stockholders following a reorganization, or as part of a section 355 distribution, to the extent of corporate earnings and profits, such gain is a dividend; the balance is capital gain.[187] "Boot" in a section 355 distribution not involving an exchange of stock is treated as a dividend distribution under section 301.[188]

Securities are always treated as "boot" to the extent the principal (face) amount received by a stockholder in *any* form of nontaxable exchange or distribution exceeds the principal amount of securities surrendered.[189] The *Adams* and *Bazley*[190] cases are thus codified.

h. Exchanges of stock for stock in the same corporation. Section 1036 of the 1954 Code continues section 112(b)(2) of the 1939 Code and permits tax-free exchanges of common stock for common stock, or preferred stock for preferred stock, in the same corporation.[191]

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[182] 1954 IRC § 355(b)(1)(B); 1939 IRC § 112(b)(11).

[183] 1954 IRC § 355(b)(2). *See* Sen. Rep. No. 1622, above, 268; H.R. Rep. (Conference) No. 2543, above, 37, 38.

[184] 1954 IRC § 355(b)(2)(C). Sen. Rep. No. 1622, above, 268; H.R. Rep. No. 2543 (Conference), above, 37, 38. Investment assets, or other nonbusiness asset groupings cannot be distributed tax free, nor can they be used to acquire a business to be distributed tax free within five years from acquisition. Possibly assets held for productive use, which do not themselves constitute a business, can be exchanged tax free for a business and that spun-off tax free within five years. Consider also a purchase of business tax free to the seller under 1954 IRC § 337, or 1954 IRC § 351 acquisition of stock of a controlled corporation solely for cash.

[185] 1954 IRC § 355(b)(2)(D), H.R. Rep. No. 2543, above, 37, 38. Stock of a controlled corporation acquired within five years of distribution, in a transaction in which *any* taxable gain or loss was recognized is treated as "boot" and not as stock. It is only considered stock for the limited purpose of ascertaining whether the necessary 80 per cent has been distributed. 1954 IRC § 355(a)(3). If a corporation purchases 80 per cent or more of the stock of a subsidiary within five years of its distribution, the distribution of such stock can never be tax free under § 355. H.R. Rep. (Conference) No. 2543, above, 38.

[186] Cf. 1954 IRC § 356 with 1939 IRC §§ 112(c) and 112(d).

[187] 1954 IRC § 356(a). 1939 IRC § 112(c). No loss is ever recognized; 1954 IRC § 356(c); 1939 IRC § 112(e).

[188] 1954 IRC § 356(b). No loss is ever recognized; 1954 IRC § 356(c). Any stock transferred in exchange for 1954 IRC § 306 stock acquires the character of § 306 stock. Any "boot" distributed with respect to § 306 stock is taxed according to 1954 IRC § 301 as a dividend distribution, and § 306. 1954 IRC § 356(e).

[189] 1954 IRC § 356(d).

[190] 331 U.S. 737 (1947).

i. Holding period. New rules have been included in section 1223 of the 1954 Code, relating to the holding period of assets. Where property is acquired with a basis determined by reference to the property transferred, the holding period of the property exchanged is "tacked on" to the property acquired in the case of exchanges occurring after March 1, 1954, *only* if the property exchanged as a capital asset or a depreciable asset or real property used in the trade or business.[192]

The "holding period of old stock is also tacked on" to distributions received in spin-offs under section 355 (and section 112(b)(11) of the 1939 Code) and to tax-free stock dividends, whether before or after January 1, 1954.[193]

j. Treasury stock. A conflict in existing case law[194] respecting the treatment of sales and purchases of treasury stock is resolved by section 1032 of the 1954 Code. It provides that there shall be no gain or loss recognized to a corporation upon the sale or exchange of its stock, including treasury stock.

5. Carryovers

a. Carryovers in corporate acquisitions. Under the 1939 Code, there was considerable confusion as to what tax attributes were carried over to a successor corporation in a nontaxable intercorporate exchange.[195] Section 381 of the 1954 Code now provides specific rules for the treatment of 19 separate tax items.

These new rules apply *only* when there is a nontaxable reorganization involving a transfer of substantially all the assets of the transferor to the acquiring corporation, followed by a distribution by the transferor of all of the stock, securities, and "boot" received in the transfer, together with all its other property.[196] They also apply to nontaxable intercorporate liquidations under section 332 where the basis of the assets in the hands of the acquiring corporation is the same as in the hands of the transferor.[197] Divisive reorganizations are excluded.

It is generally intended that the tax consequences be the same regardless of which corporation is the transferor and which the acquiring corporation.[198] However, the taxable year of the transferor corporation ends on the date the transfer of assets is completed,[199] and the acquiring corporation cannot carry back against the transferor's income any net operating losses it sustains after that date.[200]

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[191] The basis of the stock and other property received by the stockholder is the same as the basis of the stock exchanged, decreased by any money received or any liability assumed or subject to which the property was received by the transferee, and increased by any gain recognized. 1954 IRC § 1031(d); 1939 IRC § 113(a)(6). If there is "boot" involved, gain on the exchange is taxed to the extent of the "boot." 1954 IRC § 1031(b); 1939 IRC § 112(c)(1). No loss is recognized. 1954 IRC § 1031(c); 1939 IRC § 112(e).

[192] 1954 IRC § 1223(1); 1939 IRC § 117(h), changing the rule of *Commissioner* v. *Gracey*, 159 F. 2d 324 (5 Cir. 1947). It is no longer possible to transfer inventory or other noncapital assets to a controlled corporation, and tack on the holding period of such assets to the stock and securities received which are capital assets.

[193] *See* Sen. Rep. No. 1622, above, 432, 433.

[194] Cf. *Commissioner* v. *Landers Corp.*, 210 F. 2d 188 (6 Cir. 1954), rev'g 11 T.C.M. 577 (1952) with *Timken-Detroit-Axle Co.*, 21 T.C. 769 (1954), non-acq. 1954-38 IRB 5.

[195] H.R. Rep. No. 1337, above, 41; Sen. Rep. No. 1622, above, 52.

[196] 1954 IRC § 381 (a)(2). Intercorporate transfers under 1954 IRC § 351 alone are not included. Divisive reorganizations are excluded—1954 IRC § 381 applies only to liquidations and reorganizations subject to the Internal Revenue Code of 1954.

[197] 1954 IRC § 381(a)(1).

[198] *See* footnote 195.

The more important tax attributes are treated generally as follows:

Net operating losses of the predecessor are carried forward against the net income of the successor corporation, beginning with the first year which ends after the date of the transfer of assets.[201]

The *Sansome*[202] and the *Phipps*[203] rules, dealing with carryover of earnings and profits and deficits are both modified. Earnings and profits of predecessor and successor corporations are combined.[204] Deficits of either are preserved but are absorbed only by earnings and profits of the successor corporation accumulated after the date of the transfer.[205]

Capital losses of the predecessor are carried forward against capital gains of the successor.[206]

Accounting methods of the predecessor, and its method of computing inventory are continued in the successor, unless a difference in methods compels resort to regulations to be promulgated.[207]

The method of determining depreciation used by the predecessor is carried into the successor, with respect to that portion of the basis of assets derived by reference to the predecessor.[208]

Prepaid income elections are preserved to the successor unless it is on the cash basis.[209]

Obligations of the predecessor assumed by the successor, which become liabilities after the transfer are deductible by the successor if they would have been deductible by the predecessor on payment, and if they do not constitute consideration for the transfer.[210]

b. Limitations on the acquisition of corporations with net operating loss carryovers. Section 129 of the 1939 Code was an effort to prevent the purchase of companies with net operating loss carryovers, where the principal purpose of the acquisition was evasion or avoidance of income taxes "by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy.[211] The section was generally ineffective since acquisition of the stock of a loss company for the purpose of having it carry on a profitable business was not the securing of a deduction which the loss corporation did not already enjoy.[212]

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[199] 1954 IRC § 381(b)(1).

[200] 1954 IRC § 381(b)(3).

[201] 1954 IRC § 381(c)(1).

[202] *See* footnote 16, above.

[203] *See* footnote 19, above.

[204] 1954 IRC § 381(c)(2)(A).

[205] 1954 IRC § 381(c)(2)(B).

[206] 1954 IRC § 381(c)(3). Excess charitable contributions of the predecessor are carried forward against the successor. 1954 IRC § 381(c)(19).

[207] 1954 IRC § 381(c)(4) and (5).

[208] 1954 IRC § 381(c)(6).

[209] 1954 IRC § 381(c)(7). (1) Contributions to pension and profit sharing trusts, and other exempt employee plans (§ 381(c)(11)), (2) recovery exclusions under the "tax benefit" rules (§ 381(c)(12)), (3) income from installment obligations (§ 381(c)(8)), involuntary conversions (§ 381(c)(13)), (4) payment of certain "personal holding company indebtedness" incurred prior to January 1, 1934 (§ 381(c)(15)), (5) certain deferred exploration and development expenses (§ 381(c)(10)), (6) amortization of bond discount and premium (§ 381(c)(9)), (7) deficiency dividends for personal holding company purposes (§ 381(c)(17)), and (8) percentage completion on mine "tailings" (§ 381(c)(18)), are all treated as if the successor were the predecessor, for purposes of income and deductions.

[210] See 1954 IRC § 381(c)(16).

Section 269 of the 1954 Code continues the provisions of section 129. In addition, it adds a "presumption" that the interdicted purpose occurs if after March 1, 1954 the consideration paid by a person for the stock of a corporation is "substantially disproportionate" to the sum of: (1) the adjusted basis of the property of the corporation whose stock was acquired, and (2) "the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such person or corporation otherwise than as a result of such acquisition." [213] "Substantially disproportionate" consideration is said to mean "substantially less." [214]

Do the stockholders acquire any "tax benefits" by acquiring a loss company? The loss corporation does not secure any tax benefit by the acquisition of its stock by new owners. Furthermore, the fact that the consideration paid is less than the adjusted basis of the property of the corporation seems a completely meaningless test, since the consideration in any arm's-length purchase will always be based on fair market value and not on adjusted basis. It is difficult to see the application of this "tax benefit" rule.

Further to prevent "trafficking" in loss companies, section 382(a) of the 1954 Code provides new rules to deny loss carryovers when new stockholders purchase[215] 50 percentage points or more of the fair market value of a loss company's outstanding stock [216] during a two-year period,[217] *and* where the company ". . . has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership of the fair market value of such stock, ..."[218]

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[211] See 1939 IRC § 129(a)(1).

[212] Cf. *Alprosa Watch Corp.*, 11 T.C. 240 (1948), *Wage, Inc.*, 19 T.C. 249 (1952) acq. 1954-30 I.R.B. 5.

[213] 1954 IRC § 269(c). This "presumption" is apparently "prima facie evidence" only, rather than a determination. Sen. Rep. No. 1622, above, 228; H.R. Rep. (Conference) No. 2543, above, 32, 33. The provisions of 1954 IRC § 269(a)(2); 1939 IRC § 129(a), as affected by the "presumption," are not discussed since they are not of general application.

[214] H.R. Rep. No. 1337, above, A67; Sen. Rep. No. 1622, above, 228. The "control" necessary to invoke these provisions is 50 per cent stock ownership rather than the customary 80 per cent found in Subchapter C.

[215] "Purchase" is acquisition of the stock of the loss corporation, or of stock of another corporation owning such stock, or of an interest in a partnership or trust owning such stock with a basis determined by the holder's cost. 1954 IRC § 382(a)(4). Acquisition of stock with a transferor's basis, or acquisition of stock from a related person whose stock would be considered constructively owned under 1954 IRC § 318 is not a purchase. An increase in percentage ownership because of a redemption or partial liquidation of the stock of the loss company or of another corporation owning stock in the loss company is also included.

[216] Stock does not include nonvoting preferred stock. 1954 IRC § 382(c). It is consequently possible for loss company acquisitions to be made under the new rules with the new ownership invested largerly in preferred stock with only a 49 per cent ownership of the fair market value of voting stock. In this connection, it must be observed that 51 per cent of the fair market value of voting stock is not necessarily synonymous with 51 per cent of the voting power of such stock.

[217] These rules apply year by year. Change in stock ownership is geared to the group of ten or fewer persons who own the greatest percentage of the fair market value of the outstanding stock at the end of each year. 1954 IRC § 382(a)(2). Among other rules applicable here are the attribution rules of 1954 IRC § 318. If any one or more of those persons owns 50 percentage points or more of the fair market value of the outstanding stock of the corporation at the end of such year than was owned at the beginning of that year or of the preceding taxable year, or June 22, 1954 if later than either of those dates (1954 IRC § 394(b)), the first condition for denial of the loss carryover is met. 1954 IRC § 382(a)(1)(A).

These conditions must all be met within one taxable year for the loss carryover to be denied. Thus, if the change in stock ownership occurred during 1954, and the change in business did not occur until 1956, no denial of the loss carryover to 1956 would be warranted. There would be no change in the stock ownership held by the group of ten at December 31, 1956 from the stock ownership held June 22, 1954.

If the conditions are met during one taxable year, net operating loss carryovers from all prior taxable years are disallowed in full not only for that year but also for all subsequent taxable years.

Section 382(b) of the 1954 Code limits the net operating loss carryovers in the tax-free reorganizations and liquidations specified in section 381 where there has been a change in stock ownership. For a 100 per cent loss carry-forward to the acquiring corporation, the stockholders of the loss corporation immediately before the transfer of assets must end up owning at least 20 per cent in value of the stock of the acquiring corporation, or of stock in a parent corporation controlling the acquiring corporation in an equivalent amount.[219]

If the old stockholders of the loss corporation own less than the required 20 per cent, the net operating loss carryover is reduced by 5 per cent for each 1 per cent of stock less than the required 20 per cent owned by the old loss corporation stockholders.[220] As reduced, this loss will then be carried to the first taxable year of the successor corporation ending after the transfer (properly prorated for that year) and the balance carried forward to the remaining succeeding taxable years.[221]

If the loss corporation and the acquiring corporation were owned "substantially by the same persons in the same proportion" prior to the transfer, then the loss carryovers are allowed in full.[222]

These rules are applied whether the loss corporation is the transferor and the profit corporation the acquiring corporation, or vice versa.[223]

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[218] If the loss corporation continues to carry on a trade or business in substantially the same manner as before any change in the percentage ownership of stock, the loss carryover is preserved. The acquisition of another business by the loss company will not deny it the prior losses. H.R. Rep. (Conference) No. 2543, above, 40. But what is substantial continuation? Only this negative assistance is given. "If, as a result of such an increase, the corporation shifts from one type of business to another, discontinues any except a minor portion of its business, changes its location, or otherwise fails to carry on substantially the same trade or business as was conducted before such an increase, then the condition in Subparagraph C is met." Sen. Rep. No. 1622, above, 285.

[219] 1954 IRC § 382(b)(1) and (6). If the acquiring corporation owned some stock of the loss corporation immediately prior to the transfer, there is provision for the hypothetical ownership by such corporation of stock in the acquiring corporation after the transfer for purposes of the 20 per cent stock ownership test. 1954 IRC § 382(b)(5).

[220] 1954 IRC § 382(b)(2).

[221] 1954 IRC § 382(b)(4).

[222] 1954 IRC § 382(b)(3).

[223] If any limitation of 1954 IRC § 382 applies, 1954 IRC § 269; 1939 IRC § 129 is not also to be invoked. But the fact that 1954 IRC § 382 is not applicable is not to influence the use of 1954 IRC § 269; 1939 IRC § 129. Sen. Rep. No. 1622, above, 284.

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11

How to Capitalize and Recapitalize a Business

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It is a recognized fact that the vacillation of taxpayers between incorporated and nonincorporated forms of doing business is most often motivated by the degree of largess bestowed upon each by Congress, as reflected by over-all comparative tax rates. Whether and to what extent advantages may be perpetuated and disadvantages lessened, frequently depends upon whether the taxpayer is newly incorporating his business or whether his business has previously been incorporated and its capital structure is being rearranged through a recapitalization.

This chapter deals with varied problems to be considered in the initial capitalization, as well as with those incident to the recapitalization of a corporate business.

1. Points to Consider

There are many advantages and disadvantages incident to each method of operating a business, whether it be operated as a sole proprietorship, a partnership, or a corporation. Incidental to his initial consideration of a corporation as a means of doing business, the taxpayer would do well to consider the following questions:

	Section
What will be the over-all tax effect flowing from the combined corporation-stockholder relationship—single or double taxation?	3(a), 3(b)
How will Section 531 affect dividend and tax considerations?	3(c)
What obstacles may Sections 346 and 302 present to a future attempted contraction of investment?	3(d)

Having familiarized himself with the conventional tax disadvantages of operating a business as a corporation, what steps might the taxpayer take to:

	Section
Minimize double taxation?	5(a)
Delay the impact of Section 531?	5(b)
Get greater assurance of recouping part of his investment without having the distribution taxed as ordinary income to him?	5(c)
Recoup part of his investment through deduction of a loss in full?	5(d)

Related to the foregoing considerations and bearing on the technique of capitalizing the business are the following problems:

	Section
Should capital stock alone be issued?	3, 4
What is the tax aftermath of over-capitalization?	3, 4
Should stocks and bonds be issued?	5
What is the tax aftermath of inadequate capitalization?	6

Once the corporation is under way, a determination may be made to recapitalize the existing business by changing its capital structure. Attention should be directed to the following inquiries:

	Section
What is a "recapitalization"?	7
What are the statutory requirements of a tax-free recapitalization?	7
What are the judicial requirements of a tax-free recapitalization	8
How are corporate recapitalizations affected by the Adams and Bazley cases?	9
What is the effect of the I.R.C. of 1954 on recapitalization techniques?	9(c), 9(f)

2. Hypothetical Case

Let us assume that X and Y each has $250,000 to invest in a business. Because of the 52 per cent maximum corporate income tax rate, as contrasted with their own 65 per cent and 72 per cent individual brackets, respectively, they form the XY Corporation. The authorized and outstanding capital is $500,000, consisting of 5,000 shares of common stock, each of the par value of $100. X and Y each receives 2,500 shares for his respective cash investment of $250,000. Each draws a salary of $20,000 per annum and each has, in addition, substantial outside income. The XY Corporation prospers during the ensuing years.

3. Conventional Advantages and Disadvantages

a. Lower rate on single tax. When the incentive for the conduct of a new business, in corporate form, is the attractiveness of the maximum over-all corporate tax rate, the parties should recognize that any such ceiling will obtain only where a single tax is involved. It may be observed that corporations frequently pay no dividends for several years after organization and that, at any rate, they seldom pay out all of their earnings. In the former instance, the corporate entity, like other taxpayers, would pay a tax on its income. The earnings remaining after payment of such taxes would remain within the corporation, with no tax liability on the stockholders in respect to such undistributed funds.

When part of the corporate earnings are distributed, the disadvantages set forth in (b) should be considered.

b. Double taxation. In the event that X and Y wish to withdraw some of the corporate earnings remaining after taxes, they may vote to have the XY Corporation declare and pay a dividend. The effect will be to minimize the advantage of the over-all maximum tax rate, inasmuch as the latter will apply solely to that portion of the corporate earnings left undistributed. That portion which is being distributed will have already been subjected to income tax on its way into the corporate till. It will again be subjected to tax, at the applicable individual rates, on its way out of the corporate, and into each respective individual's, coffers. In other words, if the corporate earnings for a particular taxable year equal $50,000, so that the tax thereon is $20,500 (after allowance of the $25,000 exemption for surtax purposes), the net earnings after taxes (or $29,500) will be taxed to X and Y at their respective rates of 65 per cent and 72 per cent (the extent to which such earnings and profits are distributed) after application of the dividends received credit and the dividend exclusion as provided in Sections 34 and 116, respectively, of the 1954 Internal Revenue Code.

c. Section 531. The XY Corporation can avoid the impact of the double tax by not paying any dividends, or at least mitigate it, by paying part of its earnings and profits as dividends to its stockholders. The lurking danger behind such action, however, is Section 531 which imposes a surtax on corporations formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its earnings or profits to accumulate instead of being distributed.[1]

Section 531 was not designed to stunt corporate growth, since funds needed for plant expansion, increased working capital, necessary reserves, or other legitimate corporate needs, including the reasonably anticipated needs of the business, may not be deemed unreasonable accumulations within the tenor of the section.[2] Whether or not it does in practice is a matter of varying opinion.

The plight of the corporation may be reduced to this sad alternative: if the corporation distributes its earnings and profits to its stockholders, there is double taxation. But, if the corporation accumulates its earnings and profits beyond the reasonable needs of the business, including the reasonably anticipated needs, it may be subjecting itself to a further surtax superimposed upon its normal and surtax rates. In many instances, the choice of alternatives will depend upon simple arithmetical comparatives.

The surtax imposed by Section 531 is 27½ per cent of the amount of the accumulated taxable income, as defined by the Code in Section 535, not in excess of $100,000, plus 38½ per cent of such income in excess of $100,000.[3] To illustrate what the over-all effective tax would be, let us continue to assume that corporate earnings for the year in the amount of $50,000 were reduced to net earnings of $29,500, after allowance of the surtax exemption and after application of the 52 per cent rate, resulting in a tax of $20,500. Let us assume, further that the net earnings of $29,500 were subjected to the 27½ per cent rate imposed by Section 531 resulting in an accumulated earnings tax of $8,112. Total taxes would, accordingly, equal $28,612, or approximately 57 per cent of the original earnings and profits. It may be stated that this effective tax rate is still less than the assumed individual rates for X and Y, but it should be noted that after the corporation has paid out 57 per cent of its net income in taxes, X and Y are still obliged to pay an ordinary tax upon dividend income if each wishes to reach his allocable share of the remaining 43 per cent.[4]

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[1] 1954 IRC § 531; 1939 IRC § 102.

[2] *See* Jacob Mertens, Jr., *Law of Federal Income Taxation,* Vol. 7, § 40.11. Chicago: Callaghan and Company, 1943. 1954 IRC § 537.

[3] 1954 IRC § 531; 1939 IRC § 102(a).

d. Partial liquidations under Section 346 and redemptions under Section 302. It has been shown that if the corporate earnings are distributed to X and Y as dividends, such earnings will be taxed to them in their entirety at ordinary rates. Such a result influenced many taxpayers under the 1939 Internal Revenue Code to attempt to cast corporate distributions in the form of liquidating dividends within Section 115(c) of such Code, an accompaniment of which was a cancellation or redemption of stock.[5]

Once such a cancellation and redemption occurred even though intended to be in partial liquidation of the company, the distribution might have been held to be within the scope of Section 115(g) of the 1939 Internal Revenue Code. This provided that if a corporation cancelled or redeemed its stock at such a time and in such a manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the distribution was to be treated as a taxable dividend, to the extent that it represented a distribution of earnings or profits accumulated after February 28, 1913.[6]

Whether such a distribution was deemed to be within Section 115(g) or Section 115(c) was extremely important, taxwise. If the distribution was held to be essentially equivalent, the *entire* distribution constituted ordinary dividend income to the stockholder to the extent to which it represented earnings and profits and was taxable at ordinary rates. If the distribution was held to be a liquidating dividend, only the gain upon liquidation over basis was taxed, and at capital gain rather than ordinary rates.

The foregoing attempts to cast redemptions in the form of partial liquidations gave rise to much litigation. Success or failure in the quest for capital gains seemed to depend primarily upon whether there was an actual contraction of business activities.[7] The 1954 Internal Revenue Code adopts this "termination of a business" test as an alternative standard for treatment of a redemption as a distribution in partial liquidation.[8]

Generally, the new Code defines a distribution in partial liquidation as one of a series of distributions in redemption of all the stock of a corporation pursuant to a plan, or, a distribution in redemption not essentially equivalent to a dividend but which is made pursuant to a plan and occurs during the taxable year of the adoption of the plan or the following taxable year.[9] The second test of the statute ("termination of a business") has already been mentioned. The conditions necessary in order to accomplish a partial liquidation within the "termination" rules are as follows:

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[4] *See* Milton R. Schlesinger, "'Thin' Incorporations: Income Tax Advantages and Pitfalls," *Harvard Law Review*, November 1947, Vol. 61, pages 50, 52-53.

[5] § 115(c) provided that amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation shall be treated as in part or full payment in exchange for the stock. § 115(i) of the 1939 IRC defined partial liquidation as a distribution by a corporation in complete cancellation or redemption of a part of its stock or one of a series of such distributions, as to all or a part of its stock.

[6] For an analysis of § 115(g) of the 1939 IRC, criteria of taxability and cases thereunder, *see* Sydney A. Gutkin and David Beck, "Stock Redemptions as Taxable Events under Section 115(g)," *Taxes*, December 1946, Vol. 24, page 1,172.

[7] For example, *L. M. Lockhart*, 8 T.C. 436 (1947); *Joseph W. Imler*, 11 T.C. 836 (1948).

[8] 1954 IRC § 346(b). No counterpart existed in the 1939 IRC.

1. The distribution must be attributable to the corporation's ceasing to conduct a trade or business; or
2. Consists of the assets of the terminated business (or the proceeds from the sale thereof); and
3. Such terminated business was actively conducted for five years immediately prior to distribution and was not acquired in a taxable (gain or loss) transaction during such period; and
4. The distributing corporation must continue the active conduct of its other business which meets the requirements of "3" above.

It would appear that the failure of a purported partial liquidation to fall within the specific limitations of the "termination" tests would necessitate the application of the general definition. Of course, it is to be preferred that the distribution and redemption be made to fit into the "termination" category so that the tax consequences may be predicted with certainty. It is believed that the general test of the statute should not be narrowed in its application and deemed to mean merely the same as the "termination" rules. The latter exemplify one type of situation which will automatically give rise to capital gain. Failure to qualify under the mechanical tests for termination of a business should not be interpreted by the Internal Revenue Service as a failure to constitute a partial liquidation. The general definition is not so restricted in the statute.[10] However, even though it fails to qualify as a partial liquidation under Section 346, a distribution in redemption of stock may nevertheless result in capital gain to the stockholder under Section 302.

The 1954 Internal Revenue Code adopts the general rule that a distribution by a corporation in redemption of its stock shall be treated as a dividend, *unless* the redemption satisfies any one of the four specified conditions set forth below. If any one of such conditions is satisfied, a redemption will constitute a distribution in full or part payment in exchange for the stock, viz., capital gain.[11] Prior to June 22, 1954, redemptions were subject to the 1939 Internal Revenue Code and their taxability depended upon whether or not the effect thereof was essentially equivalent to a dividend under Section 115(g)(1) of said Code.

1. The redemption is not essentially equivalent to a dividend. § 302(b)(1).
2. The redemption is substantially disproportionate and the shareholder owns less than 50 per cent of the total combined voting power immediately after the redemption. § 302(b)(2).
3. The redemption constitutes the complete termination of the shareholder's stock interest in the corporation. § 302(b)(3).

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[9] 1954 IRC § 346(a). The 1939 IRC definition of partial liquidation was found in § 115(i); *see* footnote 5, above.

[10] However the Senate Report, No. 1622, 83d Cong. 2d Sess. 262 (1954) states that the general definition was also intended to cover the contraction cases. Many problems and much uncertainty remain. *See* discussion thereof in Cohen, Gelberg, Surrey, Tarleau & Warren, "Corporate Liquidations Under the IRC of 1954," *Columbia Law Review*, January 1955, Vol. 55, pages 37, 51.

[11] 1954 IRC §§ 302(a) and § 301.

4. The redemption is of stock issued by a railroad corporation pursuant to a plan of reorganization under Section 77 of the Bankruptcy Act. § 302(b)(4).

Presumably in order to prevent tax avoidance, the new law provides that in determining stock ownership (for redemption and other purposes) a shareholder shall be deemed to own stock held by members of his family or by partnerships, estates, trusts, or corporations in which he has certain specific interests, and a person holding an option to acquire stock is considered as owning the stock subject to the option.[12] Thus, for purposes of determining whether a redemption of stock qualifies (under the rules listed above) as substantially disproportionate or as a complete termination of the shareholder's interest, the selling shareholder or his estate would be considered as owning all of the stock held by others under the foregoing rules and accordingly, the redemption might not qualify for capital gains treatment. Moreover, severe limitations have been imposed upon the reacquisition of an interest in the corporation, where the distribution in redemption is in complete termination of a stockholder's interest.[13]

Capital gain may result from either avenue of approach: partial liquidation under Section 346 or redemption under Section 302. But the sanctuary afforded by the partial liquidation label guarantees capital gain treatment without incurring the possible disadvantages inherent in the redemption provisions of Section 302, such as the ten year rule against reacquisition of an interest and the rules as to recognition of gain to the distributing corporation on distributions of LIFO inventory or assets with liabilities in excess of basis.[14] Partial liquidations are removed from the application of such provisions.[15]

4. Maximizing Advantages and Minimizing Disadvantages

It is quite apparent, from the foregoing, that the XY Corporation may be said to have been organized in a manner singularly lacking in imagination and ingenuity. Although it is true that the normal concomitants of a corporation, such as limited personal liability on the part of the stockholders, continuity of enterprise, and centralized management, are present, many of the features normally availed of for the purpose of minimizing corporate taxes are lacking. This is due to the fact that the XY Corporation may be said to be overcapitalized, since the entire amount of $500,000 invested by the stockholders was used to purchase stock.

Let us assume that when the XY Corporation was organized, its authorized and outstanding capital was $300,000, consisting of 3,000 shares of common stock, each of the par value of $100, and that it issued $200,000 in bonds.[16] For the amount of

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[12] 1954 IRC § 318.

[13] *See* the so-called "10-year" rule in 1954 IRC § 302(c)(2)(A).

[14] 1954 IRC § 311(b) and (c).

[15] *See* Senate Report No. 1622, footnote 10, above. *See also*, 1954 IRC § 336.

[16] One of the considerations frequently overlooked by counsel in capitalizing a corporation is the possible savings in Federal stamp taxes to be effected upon the original issuance and transfer of stock by the usage of shares of low par value. For example, the rate of tax upon the original issue of par stock, based upon aggregate face value, is 11 cents per $100 face value or fraction thereof. If 3,000 shares, each of the par value of $100, are authorized and issued, the stamp tax will be 11 cents times 3,000, or $330. If 3,000 shares, each of the par value of $1, are issued, the tax on $3,000 will be $3.30. Upon the transfer of the $100 par value shares, the tax will be 5 cents per each $100 face value or fraction thereof (based on aggregate face values) where the

$250,000 which X and Y each paid to the company, each received 1,500 shares of common stock, totalling $150,000, and $100,000 in bonds.

This "thinning" operation will, if condoned by the courts and the Treasury, have salutary effects upon both the corporation and its stockholders in several respects. Whether and to what extent it will be condoned depends upon how "thin" the corporation is made. Both phases of the problem are hereinafter set forth.

5. Potential Tax Advantages of a "Thinned" Corporation[17]

a. Double taxation minimized. The disadvantage of double taxation, previously set forth, is, in some measure, alleviated by the issuance of stock and bonds. The reason for this is that a distribution by a corporation of a dividend affords no deduction to the corporation with respect to the dividend, but amounts accrued or paid to bondholders are deductible as interest by the corporation.[18] Thus, there is a deduction in the latter instance to the corporation in an amount corresponding to that paid as interest. Insofar as the recipients of the payment are concerned, both dividends and interest are taxed at ordinary rates. However, individuals are now granted a dividend exclusion and credit not formerly available under the 1939 Code. Section 116 of the new law excludes from gross income the first $50 of dividends received from domestic business corporations. Section 34 provides for a credit against the income tax of 4 per cent of dividends received after July 31, 1954, with a limitation of 2 per cent of taxable income for years prior to January 1, 1955 and 4 per cent thereafter. The double tax on corporate earnings distributed as dividends is thus softened in its impact upon the taxpayer. No such exclusion and credit are granted for corporate distributions characterized as interest. When the receiving stockholder is a corporation, interest is taxed at normal corporate rates, whereas dividends received from another domestic corporation are subject to an 85 per cent credit.[19]

Consideration should be given to the use of bonds with increasing values, but paying no interest. Let us assume that the debentures are in registered form and provide that, at the end of ten years, the holder of each $1,000 unit will be entitled to receive $1,415. This is the equivalent of the original investment with interest at the rate of 3½ per cent per annum, compounded semi-annually. Assume, further, that the holder may surrender them on any anniversary date after three months' notice at a fixed dollar amount, computed by adding to the original cost simple interest at the rate of 3 per cent per annum. There is no provision for current interest.

The corporation reporting income on the accrual basis may deduct accrued interest each year, computed at the 3 per cent rate. It had been understood under the

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selling price is under $20, or six cents where the selling price is $20 or over. Accordingly, the difference in tax will be computed in the same manner. Where no par shares are issued, the applicable rates of tax are applied on issuance and transfer to unit shares rather than aggregates and may well result in greater levies. 1954 IRC §§ 4301 and 4321; 1939 IRC § 1802. Consideration should also be given to economies effected in state filing fees through the usage of small par value shares. See General Corporation Law of New Jersey, 14:16-1, 2.

[17] *See* Schlesinger, footnote 4, above. Myron Semmel, "Tax Consequences of Inadequate Capitalization," *Columbia Law Review,* March 1948, Vol. 48, page 202.'

[18] 1954 IRC § 163; 1939 IRC § 23(b).

[19] 1954 IRC § 243; 1939 IRC § 26(b)(1).

1939 Code that the bondholder, presumably on the cash basis, would not have ordinary interest income, but rather, upon the redemption of the bonds by the corporation, would have gain (measured by the difference between his cost basis and what he received) subjected to preferred treatment under the capital gain provisions of such Code.[20] In this connection, careful consideration had to be given to the position of the Bureau of Internal Revenue set forth in its rulings, which required re-examination of the problem.[21]

Under Section 1232 of the 1954 Code amounts received by the holder on retirement of bonds or other evidences of indebtedness are considered as received in exchange therefor, regardless of whether in registered form or with coupons attached, as was formerly required under the 1939 Code. The new statute is by its terms limited to bonds which are capital assets in the hands of the taxpayer. Bonds issued at a discount after December 31, 1954 are subject to a special rule, if held more than six months by the taxpayer. Any gain on the sale, exchange or retirement of such bonds that is due to the original issue discount is taxable as ordinary income. Gain in excess of such amount is taxed as long term capital gain (assuming the bond is held as a capital asset). "Original issue discount" for purposes of this rule means the difference between the issue price and the stated redemption price upon maturity of the bond.

b. Section 531 impact delayed. Inasmuch as Section 531 is predicated on the unreasonable accumulation of surplus beyond the actual or anticipated needs of the business, it is probable that a corporation, obligated to pay interest on bonds and to amortize them, will reach the permitted limit of surplus accumulation at a later date than one without such commitments. Certainly, surplus accumulations in the XY Corporation, organized solely with capital stock outstanding, will be at a more rapid rate than in the XY Corporation, (1) organized with stock and bonds outstanding, (2) interest and amortization on the bonds being paid, but (3) dividends on the stock not being paid.

c. Recouping investment through retirement. It has been shown that Section 302 taxes, as an ordinary dividend, distributions in redemption of stock which do not qualify under the provisions of such section. The section does not apply to bonds or securities other than stock. Accordingly, a retirement of bonds would usually enable the investors to recoup part or all of their investment without any of the dangers of taxation as ordinary income incident to Section 302. The tax consequences, to the recipients of the corporate monies, would be based upon gain or loss, measured by the difference between the amount received in redemption of such bonds and the basis therefor.[22]

d. Recouping investment through loss deduction. A further potential advantage of a corporation thinned through the use of bonds and stock, instead of stock alone, may come to fruition when a loss is sustained by reason of the worthlessness of the security in question. Section 165 treats as capital losses, losses from the worthlessness both of stock and of bonds, of debentures, notes, certificates, or of other evidences of indebtedness with interest coupons or in registered form.[23] There are instances, however, in which deductions for worthless debts may be taken in full, while losses for worthless stock may not. This may occur when the bad debt is shown to have been incurred in the individual taxpayer's trade or business and is not evidenced by any of the securities previously enumerated.

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[20] 1939 IRC § 117(f). Seemingly, the same treatment would be accorded Series E Bonds issued by the United States. However, specific provisions in the authorizing statute require the contrary result.

[21] See Rev. Rul. 119, 1953 P-H Fed. Tax Serv. ¶ 76,568.

[22] 1954 IRC § 1232; 1939 IRC § 117(f). The foregoing discussion assumes the tax validity of the bonds, as bonds. See Section 6, below.

6. How "Thin" May, or Should, a Corporation Be Made?

Suppose the XY Corporation should issue $1,000 in common stock and $499,000 in bonds to X and Y, in equal shares. In point of cash funds for the corporation, the amount available to it would be the same as if no bonds but capital stock alone were issued. From the aspect of X and Y, each would have advanced the amount of $250,000. But the balance sheet of the corporation will now differ, as will the relationship of X and Y to the company. The corporation will now show only $1,000 in its capital account but will show a liability in bonds payable in the amount of $499,000.[24] X and Y will have a total proprietary interest as stockholders amounting to $1,000, and will have the position of creditors to the extent of the remaining $499,000.

Will the financing of the company in the foregoing manner be sustained for tax purposes or will there be strong likelihood that the bonds will not be recognized for tax purposes as obligations of the corporation?

Not more than a few years ago, the danger that such a financing would be ignored for tax purposes was not formidable. As a result of the Supreme Court's meaningful dictum in *John Kelley Co.* v. *Commissioner*,[25] taxpayers would do well today to approach, with a great degree of apprehension, any arrangement consisting of the issuance of corporate bonds embracing virtually the entire value of the corporation's assets, when the stock issued represents only a nominal value. The reason for the change in judicial climate is the following expression by the Court, even though the factor of inadequate capitalization was not considered in the tribunal: "As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure." [26] These words have raised in many minds queries with respect to the outermost fringe of permissible "thinness."

a. Thinning processes. In the foregoing discussion, it has been assumed that X and Y were not engaged in any venture prior to their association for the purpose of forming the XY Corporation. It has been indicated that their choice lay between forming a company in which they invested funds as stockholders alone or as a combination stockholder-creditor. Choice of the latter alternative was referred to as one of the thinning processes. There are others, which should be briefly noted.[27]

Let us assume, without regard to Y, that X has conducted a business as a sole proprietorship and that the balance sheet of the business, immediately prior to the incorporation, shows assets of $500,000, liabilities of $200,000 and a capital account of $300,000. Of the assets, $150,000 represents cash, $50,000 represents United States Bonds and other liquid securities, accounts and notes receivable amount to $100,000 and the remaining $200,000 consists of inventory, plant and equipment, and miscellaneous assets. Of the liabilities, $150,000 represents accounts and notes payable, and the remaining $50,000 represents miscellaneous liabilities. Accordingly, the business has a net worth of $300,000.

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[23] 1939 IRC § 23(g) and § 23(k).

[24] It is to be understood that the obligations of a corporation, when "thinned," are not limited to the use of bonds or debentures, but may include notes or other evidences of indebtedness.

[25] 326 U.S. 521 (1946).

[26] *Ibid.*, page 526.

[27] It is not within the scope of this chapter to delve into methods and consequences of incorporating "thin," although brief mention thereof is deemed advisable for a better understanding of the broader considerations which are within the purview of our inquiry. For treatment thereof, see Schlesinger, footnote 4, above; Semmel, footnote 17, above.

For purposes of this discussion, let us assume that if, upon the incorporation of the business, all the assets of the enterprise, subject to liabilities, are transferred to the new corporation, there will be an overcapitalization. Accordingly, the new corporation might be thinned if X withholds $100,000 in cash. The cash account would thus be reduced by $100,000, as would the amount of total assets, and a corresponding reduction would take place in the capital account. If X concludes that the business does not require more than $350,000 of gross assets, he might in addition withold $50,000 of bonds and/or receivables, thereby reducing his capital account to $150,000. If the transfer of the assets took place at this point, X would receive, in exchange for his net worth in the sole proprietorship, $150,000 of the capital stock of the new corporation. In spite of the initial withholding, however, the suggestion might still be made that the corporation is overcapitalized.

As a further thinning process, X might have the corporation issue bonds as well as stock in exchange for the transfer of the assets and liabilities of the sole proprietorship. Thus, instead of receiving $150,000 in capital stock, X might receive some part of his investment in bonds and the balance in stock. The corporation will now be in the position of making the most of the potential tax advantages previously outlined in a situation in which both forms of security are outstanding.

A note of caution is necessary at this point. Under Section 357(c) of the 1954 Internal Revenue Code, if the total amount of the liabilities taken over by the corporation, whether assumed or to which the property is subject, exceeds the total of the adjusted basis of the property transferred to the corporation, then such excess is taxed to X (the transferor) as capital gain or ordinary income, as the case may be.

The final step in the thinning process would be accomplished when the corporation redeemed the outstanding bonds. The effect of such a redemption would be to enable X, a stockholder-creditor, to withdraw a further portion of his investment tax free. This assumes that the corporation has not been over-thinned and that the bonds are recognized as such for tax purposes, as discussed later in subsection (b).

Great care should be exercised in the use of such thinning processes when a partnership is the predecessor of the corporation. The possibility of taxable gain to the partners, upon the liquidation of a partnership which distributes cash as well as other assets preparatory to being incorporated, should be recognized.[28]

b. When are bonds not bonds for tax purposes? The answer to this question may be stated to be: whenever, in the eyes of the courts, that outermost fringe of permissible "thinness" has been transcended. To determine whether a particular transaction will or will not be condoned, one should pragmatically look to the treatment accorded similar transactions by the courts under circumstances similar or comparable to those being contemplated. Although judicial inquiry into the nature of the security is commonly made by examination of the usual criteria, such as nomenclature, fixed maturity date, definite rate of interest, intent of the parties, certainty of payment, and subordination to creditors, the scope of inquiry is often deeper in purpose.

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[28] See Schlesinger, *op. cit.*, pages 68-78. Careful exploration should also be made of the requirements and pitfalls incident to 1954 IRC § 351; 1939 IRC § 112(b)(5).

For example, in one of the earliest cases in point, *Edward G. Janeway,*[29] the Tax Court was confronted with a situation in which the taxpayers and others advanced funds to a corporation in return for notes and 6/10 of a share of stock for each $1,000 so advanced. The corporation had no other assets or capital, except these advances, and upon its dissolution, the taxpayer contended that the loss sustained upon the notes represented bad debts. In holding that the notes were to be considered as shares of stock, the Court pointed to the dual stockholder-creditor role of the petitioners and stated:

> Though the advances made were, by the issuance of the notes, given the appearance of loans, the possibility of repayment was no stronger than the business and its possible success. No other money was paid in for stock, so that the advances constituted the corporation's only source of working capital. . . . The effect of what was done is the same as if the petitioners and the other stockholders purchased the stock with the money advanced, and became pro-rata owners of the corporation.[30]

In the following year, the Tax Court was again confronted with a similar issue. The facts indicated that taxpayers invested $1,000 in the capital stock of the company and lent it $14,000.[31] The Commissioner contended that the entire $15,000 represented a capital investment. The Court agreed, stating that all monies advanced by petitioners to the company were at the risk of the business, that the company had no assets other than the $15,000 put into it by petitioners, and that no differentiation could be made between the amounts invested in the stock of the corporation and the loans to it.

In ensuing years, the question of whether corporate payments constituted interest on obligations or dividends on stock was presented to the Tax Court on numerous occasions,[32] and ultimately reached the Supreme Court.[33] In *Mullin Building Cor-*

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[29] 2 T.C. 197 (1943), affirmed (2 Cir. 1945) 147 F. 2d 602.

[30] *Ibid.*, at page 202.

[31] *Michael Cohen,* T.C. Memo. Dec. Dkt. 205 (1944), affirmed (2 Cir. 1945) 148 F. 2d 336 par. 44,084 Prentice-Hall Memorandum T.C.

[32] 1432 *Broadway Corporation,* 4 T.C. 1158 (1945), affirmed (2 Cir. 1947) 160 F. 2d 885; *Cleveland Adolph Mayer Realty Corporation,* 6 T.C. 730 (1946), reversed on other grounds (6 Cir. 1947), 160 F. 2d 1012; *Thomas J. O'Neill,* T.C. Memo. Dec., Dkt. 9728 (1947) par. 47,239 Prentice-Hall Memorandum T.C.; *Mullin Building Corporation,* 9 T.C. 350 (1947) 36 AFTR 1005, affirmed (3 Cir. 1948) 167 F. 2d 1001; *Swoby Corporation,* 9 T.C. 887 (1947); *Bowersock Mills and Power Company,* T.C. Memo. Dec., Dkt. 9186 (1947) par. 47,290 Prentice-Hall Memorandum T.C., reversed (10 Cir. 1949) 172 F. 2d 904; *Toledo Blade Company,* 11 T.C. 1079 (1948) (acq.), I.R.B. No. 17, 1949. *Hemenway-Johnson Furniture Co., Inc.,* T.C. Memo. Dec. Dkt. 13648 (1948) par. 48,113 Prentice-Hall Memorandum T.C., affirmed (5 Cir. 1949) 174 F. 2d 793; *Wilshire and Western Sandwiches, Inc.,* T.C. Memo. Dec. Dkt. 10638 (1948), reversed (9 Cir. 1949) 175 F. 2d 718 par. 48,123 Prentice-Hall Memorandum T.C.; *Wetterau Grocer Company, Inc.,* T.C. Memo. Dec. Dkt. 16146 (1949) par. 49,106 Prentice-Hall Memorandum T.C.; *Kipsborough Realty Corp.,* T.C. Memo. Dec. Dkt. 27676 (1951) par. 51,291 Prentice-Hall Memorandum T.C.

[33] *Kelley Co.* v. *Commissioner,* footnote 25 above; *Talbot Mills* v. *Commissioner, ibid.*

poration,[34] a corporation was formed with 100 shares of common stock and 2,900 shares of debenture preferred stock, all of the par value of $100 per share and held proportionately by the same people. The corporation claimed that the debenture stock represented indebtedness. The Tax Court, in holding that the debenture stock was capital stock, stated that it was not necessary to create a 29 to 1 debt to capital ratio in the petitioner's financial structure. In *Swoby Corporation,*[35] the taxpayer was formed to acquire real estate and it issued, for that purpose, 200 shares of capital stock, of the par value of $1 each, and a single 99-year "Income Debenture" of the face amount of $250,000. The question was whether the debenture was an obligation or a capital investment. Applying the language of the Supreme Court in the *Kelley* case, quoted before under Section (a) of this chapter, the Tax Court held the debenture to be a capital investment, stating: "Dealing with property having a stipulated value of 'at least $250,200,' the financing selected was to create a clearly 'nominal' figure of $200 in the common stock and 'an obviously excessive debt structure' of $250,000 in the debenture." [36]

In the previously decided *Kelley* and *Talbot Mills* cases, all stock of the corporation involved was owned by a family group. In the former case, the corporation had been reorganized and $250,000 of 20-year income debenture bearer bonds had been offered only to shareholders. The bonds were assignable, bore 8 per cent noncumulative interest conditioned on sufficiency of income, were subordinated to other creditors, were redeemable at the corporation's option, and carried acceleration provisions in case of default. In the latter case, the capital invested in stock amounted to $100,000 and the instruments referred to as bonds aggregated $400,000. The Tax Court had previously held the payments to be interest in the *Kelley* case[37] and dividends in the *Talbot Mills* case.[38] The Seventh Circuit Court of Appeals reversed the former decision;[39] the First Circuit affirmed the latter.[40] On the basis of the *Dobson* rule,[41] the Supreme Court held that the Tax Court's holdings should have been affirmed in each case, there being sufficient evidence to support its conclusions that the payments constituted interest in one case and dividends in the other. The Court, as indicated by the language quoted, believed that neither case presented a situation involving a nominal amount of stock and an obviously excessive debt.

It has been pointed out that pending the formulation of a definitive rule with respect to what may constitute inadequacy of capitalization, several criteria have been suggested.[42] One such criterion is the percentage of the entire contribution to the corporate entity, which is allocated to indebtedness. Another suggestion, aimed at the rights of third parties, would consider as inadequate any capital investment when it is less than the indebtedness. In this connection, however, one should remember the Supreme Court's indication that it is not a reversible error if the Tax Court fails to find that a 4-to-1 ratio constitutes improper financing.[43] A further method of approach would consider capital inadequate if, from the point of view of a business man or financial analyst, it is not sufficient to run a business of that size and nature. Finally, it has been suggested that advances should be regarded as capital contributions if, at the time they were made, the corporation could not have borrowed from informed outside sources.

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[34] *See* footnote 32, above.

[35] *Ibid.*

[36] 9 T.C. 887, at 893.

[37] 1 T.C. 457 (1943).

[38] 3 T.C. 95 (1944).

[39] *Commissioner* v. *Kelley Co.* (7 Cir. 1944), 146 F. 2d 466, 33 AFTR 410.

[40] *Talbot Mills* v. *Commissioner* (1 Cir. 1944), 146 F. 2d 809, 33 AFTR 439.

[41] *Dobson* v. *Commissioner,* 320 U.S. 489 (1943), 31 AFTR 733.

[42] For a discussion of suggested criteria and a critique thereof, *see* Semmel, footnote 17, above, at pages 214-215.

Basically, it may be stated that each case will be dealt with on its own facts and circumstances, pending the crystallization of some objective test. It is quite conceivable that no such objective, all-inclusive test will ever be formulated, but that resort will be had to the "net effect" approach, which courts have implemented in other spheres of the tax law.[44] Whatever means are used, the end result is extremely important tax-wise.

Whether bonds are recognized as such for tax purposes, or whether they will be considered as shares of stock, will predetermine many of the tax incidents, with respect to the corporation in question. Among these are whether distributions by it are to be considered interest on bonds or dividends paid on outstanding stock; whether particular losses from the worthlessness of securities may be deducted in full as bad debts or in limited amount as worthless stock; and whether amounts distributed in redemption will be treated as distributions "essentially equivalent" to the distribution of a dividend or merely in redemption of bonds.[45]

7. Recapitalization: Definition and Statutory Requirements

The initial problem of how to capitalize a corporate business having been considered, the taxpayer may subsequently desire to effect a change in such capitalization by means of a recapitalization. Although the Code defines a reorganization as including a recapitalization,[46] nowhere does the definition of a recapitalization appear therein. It has, however, been defined to mean an arrangement whereby the stock and bonds of the corporation are adjusted as to amount, income or priority, or an agreement of all stockholders and creditors to change and increase or decrease the capitalization of the corporation.[47] Judicially, the term has been recognized to refer to the reshuffling of stock and securities within the framework of an existing entity or corporation,[48] although it is equally possible to accomplish one outside the framework of the existing corporation.

Notwithstanding that an exchange of bonds for bonds was held for many years to be a refinancing as distinguished from a recapitalization,[49] the courts have come to include such an exchange within the meaning of the latter concept.[50] The examples of recapitalizations contained in the Commissioners' regulations under the 1939 IRC [51] did not cover the typical recapitalization involving an exchange of preferred stock for preferred and common stock, whereas, the Proposed Regulations under the 1954 IRC cover this situation.[52] This may have been because the 1939 regulations were illustrative and not exhaustive, although it is a matter of speculation whether this omission was intentional. On the other hand, it is the writer's opinion that any omission of mention of an exchange, in which new bonds are received for old bonds or old stock, was designedly so.

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[43] *Talbot Mills* v. *Commissioner*, footnote 25 above.

[44] *See* Sydney A. Gutkin and David Beck, "Culbertson Case May Herald New Era in Family Partnerships," *Journal of Accountancy*, August 1949, Vol. 88, page 121.

[45] In *Emil Stein*, 46 B.T.A. 135 (1942), the Board of Tax Appeals invoked Section 115(g) of the 1939 IRC and taxed as ordinary dividends payments received on the redemption of a corporate obligation.

[46] 1954 IRC § 368(a)(1)(E); 1939 IRC § 112(g)(1)(E).

[47] William W. Cook, *Cook on Corporations*, 8th Ed., § 803. Boston: Little, Brown and Company. 1923.

[48] *Truman H. Newberry et al.* T.C. Memo. Dec., Dkts. 4122, 4123 par. 45,197 Prentice-Hall Memorandum T.C. (1945).

[49] *Walter H. Field*, 41 B.T.A. 183 (1940); I.T. 2778, XIII-1 C.B. 79 (1934).

The nonrecognition sections of the 1939 Code covering exchanges, reorganizations and recapitalizations, were contained in Section 112.[53] Sections 112(b)(2) and 112(b)(3) covered exchanges within the existing entity, although it is to be noted that the latter part of Section 112(b)(3) included an exchange with another corporation. If it was desired to accomplish a recapitalization outside the existing corporation and in conjunction with another corporation, Sections 112(b)(4), (b)(5), and (b)(6) could also have been invoked. Section 112(b)(11) permitted the tax-free separation of a corporation into two or more corporations pursuant to a spin-off reorganization.

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[50] *Commissioner* v. *Neustadt's Trust, et al.* (2 Cir. 1942), 131 F. 2d 528, 30 AFTR 320, affirming 43 B.T.A. 848 (1941); *Jeanne G. Miller*, T.C. Memo. Dec., Dkt. 291 (1944) par. 44,077 Prentice-Hall Memorandum T.C.; *Pan American Trust Co.*, T.C. Memo. Dec. Dkt. 4474 (1945) par. 45,183 Prentice-Hall Memorandum T.C.; *Mutual Fire, Marine & Inland Ins. Co.*, 12 T.C. 1057 (1949).

[51] Reg. 118, § 39.112(g)-2.

[52] (a) A corporation with $200,000 par value of bonds outstanding, instead of paying them off in cash, discharges them by issuing preferred shares to the bondholders;

(b) there is surrendered to a corporation for cancellation 25 per cent of its preferred stock in exchange for no-par-value common stock;

(c) a corporation issues preferred stock previously authorized but unissued, for outstanding common stock; or

(d) an exchange is made of a corporation's outstanding preferred stock, having certain priorities with reference to the amount and time of payment of dividends and the distribution of the corporate assets upon liquidation, for a new issue of such corporation's common stock having no such rights.

See also Proposed Reg., 1954 IRC § 1.368-2(e)(5).

[53] 1939 IRC § 112. The subsections pertinent to our discussion were:

(a) General Rule. Upon the sale or exchange of property, the entire amount of the gain or loss, determined under § 111, shall be recognized, except as hereinafter provided in this section.

(b) (2) Stock for Stock of Same Corporation. No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(b) (3) Stock for Stock on Reorganization. No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(b) (4) Same—Gain of Corporation. No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization solely for stock or securities in another corporation, a party to the reorganization.

(b) (5) Transfer to Corporation Controlled by Transferor. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; . . .

(b) (6) Property Received by Corporation on Complete Liquidation of Another. No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation.

The new Code has rearranged the foregoing sections of the statute and substantially changed the law pertaining to reorganizations, as such, although a recapitalization remains undefined.[54] Such changes will not be discussed herein except insofar as they may bear upon techniques of recapitalizing a business.

As a general proposition, all exchanges give rise to realized gains or losses. For tax purposes, however, nonrecognition depends upon the statutory provisions.[55]

The requirement for an "exchange" is generally common to the provisions herein mentioned. It is a reciprocal transfer of properties as distinguished fom the transfer of property for money.[56] Depending upon the facts, additional statutory requirements may be (a) the reorganization must take place pursuant to a plan of reorganization and (b) the corporations must be parties to the reorganization; except, however, that in divisive types of reorganizations known as split-ups, split-offs, and spin-offs, a plan of reorganization is unnecessary.[57] The exchanges in a recapitalization will, ordinarily, take place pursuant to a plan, and the corporation must necessarily be a party to the reorganization. It is, of course, best to have the plan in the corporate records, although it need not be a formal plan, provided it can be established by other evidence.[58]

8. Judicial Requirements of a Tax-Free Recapitalization: Business Purpose

Beyond the foregoing, the courts have developed and broadened the statutory definition of a reorganization. Thus, it has been said that a "corporate business purpose" must be the motivating factor of a reorganization in order to bring it within the scope of Section 112(b) of the 1939 IRC. Although the business purpose doctrine has its roots in the case of *Gregory* v. *Helvering*,[59] the implications of the doctrine came into full bloom in the *Bazley* and *Adams* decisions.[60]

The Tax Court there held that though there was a technical recapitalization in each case, formal compliance with the statute was not sufficient to make it a tax-free reorganization. It felt that the real issue was whether it had been satisfactorily established that there was a true business purpose for the operation by which new stocks and bonds were issued for the old stock. It found no legitimate

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[54] The following table will serve to locate the corresponding sections of the new law:

1939 Code Sec. No.	*1954 Code Sec. No.*
112(b)(2)	1036
112(b)(3)	354, 355
112(b)(4)	361
112(b)(5)	351
112(b)(6)	332
112(b)(11)	355

[55] 1954 IRC § 1001.

[56] *Katherine A. Spaulding*, 7 B.T.A. 588 (1927).

[57] 1954 IRC § 355(a)(2)(C).

[58] *William H. Redfield*, 34 B.T.A. 967 (1936); *C.T. Investment Co.* v. *Commissioner* (8 Cir. 1937), 88 F. 2d 582; *Hortense A. Menefee*, 46 B.T.A. 865 (1942).

[59] (2 Cir. 1934) 69 F. 2d 809, affirmed 293 U.S. 465 (1935). *See* Sydney A. Gutkin, "Recapitalizing an Existing Business," *Proceedings of New York University Fifth Annual Institute on Federal Taxation*, page 795. New York: Matthew Bender and Company, 1947.

[60] *Bazley* v. *Commissioner*, *Adams* v. *Commissioner*, both at 331 U.S. 737 (1947), 34 AFTR 1318.

corporate business purpose, but merely a desire to create a more desirable type of security for the stockholders. Such a desire was held not sufficient to show a legitimate corporate purpose within the doctrine of *Gregory* v. *Helvering.*

The Third Circuit Court of Appeals sustained the action of the Commissioner and affirmed the Tax Court in both of these cases, holding that the bonds distributed were substantially equivalent to distributions of taxable dividends. The Court stated that there was an absence of a substantial business purpose.

Both cases were covered in a single Supreme Court opinion about which several observations may be made.[61] Initially it may be observed that, notwithstanding the close association of the business purpose test with these cases, no discussion of the doctrine along the lines delineated by the Tax Court and the Circuit Court takes place.[62] Furthermore, the language of the Court seems to be akin to the "net effect" test. In particular, it is susceptible to the interpretation that any recapitalization which involves bonds, the distribution of which is deemed the essential equivalent of cash, will fall outside the scope of the reorganization provisions and into the sphere of the dividend provisions of the statute.[63] Finally, in its scrutiny of the facts, the Court emphasized that the bonds were essentially equivalent to cash and were obligations which could be retired at will. Query: has the rule any application where one or both of these factors are lacking? Query: in any determination of "net effect," may not the business purpose inquiry be essential?

Viewed from an over-all aspect, recapitalizations may be deemed to fall into three general types: (1) from stock to securities, (2) from securities to stock, and (3) from stock to stock. In the first type, we find that the corporation is apt to save on state franchise taxes because these levies are generally based on net worth.[64] The Federal corporate income taxes will also be reduced, because interest charges on the securities will decrease net profit, that reduction necessarily being greater than the reduction in tax.[65] The stockholder, on the other hand, may pay a greater tax because of a larger income. Assuming all profits have been and will be distributed as dividends, the corporation will distribute more in the form of interest and dividends after the recapitalization due to the reduction of taxes. To some extent this type of recapitalization eliminates the double taxation problem inherent wherever the corporate form of business is employed.

In the second type of recapitalization, the corporation will pay a greater tax attributable to a larger income (having eliminated interest charges). Thus the stockholder may have a smaller income and tax, because the corporation has less to distribute. And in the third type, the corporate as well as the stockholder's taxable income will remain the same.

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[61] For a discussion of the cases, see Thomas N. Tarleau, "Corporate Recapitalizations as Affected by the Adams and Bazley Cases," *Proceedings of New York University Sixth Annual Institute on Federal Taxation,* page 266. New York: Matthew Bender and Company, 1948.

[62] As a result of the Supreme Court's failure clearly to commit itself to the corporate-purpose test, the Eighth Circuit Court of Appeals rejected the corporate requirement. *Survaunt* v. *Commissioner* (8 Cir. 1947), 162 F. 2d 753.

[63] The "net effect" test appears to have been used by the Seventh Circuit in *Marion Heady* v. *Commissioner* (7 Cir. 1947), 162 F. 2d 699, 35 AFTR 1551 where it is stressed that a recapitalization will not qualify as a tax-free reorganization if the effect is a distribution of earnings and profits. The inference to be drawn from the case is that the Court might well have reached the same conclusion even if a corporate business purpose were present, where the effect was a distribution of earnings and profits.

[64] The Tax Court rejected this saving as a business purpose. *Adams* v. *Commissioner,* 5 T.C 351 (1945).

[65] Rejected as a business purpose by the Tax Court in the Adams case.

In many cases, the primary purpose is not the saving of taxes but other more compelling economic reasons. Thus, a corporation may desire to recapitalize for the purpose of refinancing its outstanding securities,[66] it may be in need of new financing,[67] or a public sale of securities is contemplated.[68] These are but a few of the various possible economic reasons for a recapitalization.

A stockholder may desire a recapitalization for a particularly personal reason, the benefit whereof inures only to the stockholder and not to the corporation.[69] Thus, there may be a desire for a more flexible capital structure to enable the stockholder to sell or give part of his business away without losing control, or perhaps it is desired to shift control to another group.[70] The stockholder may desire to be on a par with creditors, or he may wish to bail out by a public sale.[71]

In addition to the corporate business purpose doctrine developed by the courts, two other requirements have been judicially developed in defining a reorganization for statutory purposes. These requisites, (1) that there be a continuity of interest[72] and (2) the interest must be proprietary, have not as yet been applied to recapitalizations.[73] Although the Tax Court has specifically denied their application to recapitalizations,[74] the question might possibly arise upon an exchange of preferred or common stock for bonds (the holders having no other interest), inasmuch as, technically, the stockholders have, by accepting the obligations of the corporation, lost their proprietary interest. A continuity of interest is, of course, always present in a recapitalization.

9. Recapitalizations as Affected by Adams and Bazley

It is now a matter of common knowledge that the *Adams* and *Bazley* cases have substantially limited the use of bonds, debentures, and debt securities in recapitalizations where there are corporate earnings and profits available for distribution as dvidends. Even though the holding of the Supreme Court may be deemed circumscribed by the circumstance that it was based upon a fact situation involving corporate obligations, which (in *Bazley*) could be retired at will and which were considered essentially equivalent to cash, the net effect test, inferentially present in the decision, portends ominous results for the unwary. Indeed, these cases have required a re-examination of old techniques of recapitalization and a search for new ones to avoid the impact of a dividend tax, while accomplishing the same ultimate ends as before.[75]

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[66] *See* footnote 50 above.

[67] *Commissioner* v. *Capento Securities Corporation* (1 Cir. 1944), 140 F. 2d 382, 32 AFTR 56.

[68] *Bass* v. *Commissioner* (1 Cir. 1942), 129 F. 2d 300, 29 AFTR 819.

[69] The converse of this proposition is not logically correct. It is submitted that whatever a corporation accomplishes for its benefit will necessarily benefit the stockholders, inasmuch as it is the purpose of a corporation to produce greater profit for distribution to its equity holders. But see Richard H. Survaunt, 5 T.C. 665 (1945), reversed in part on another issue; *Survaunt* v. *Commissioner*, above, where the court found a "reorganization" notwithstanding it was pursuant to stockholders' personal, rather than corporate, purposes. Apparently, any such distinction has been denied in *Lewis* v. *Commissioner* (1 Cir. 1949), 176 F. 2d 646.

[70] It would appear that this purpose is only valid if the circumstances of the case indicate that control is of sufficient importance and will thus benefit the corporation. *See Jacob Fisher*, 46 B.T.A. 999 (1942).

[71] Presumably this would be classified as a stockholder purpose. But suppose some stock will be sold for the corporation as well as for the account of the stockholders? Will relative benefits be weighed?

[72] *Pinellas Ice & Cold Storage Company* v. *Commissioner*, 287 U.S. 462 (1933), 11 AFTR 1112; *Cortland Specialty Company* v. *Commissioner* (2 Cir. 1932), 60 F. 2d 937, 11 AFTR 857; *Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378 (1935), 15 AFTR 1235.

[73] *LeTulle* v. *Scofield* 308 U.S. 415 (1940); *Commissioner* v. *Segall* (6 Cir. 1940), 114 F. 2d 706, 23 AFTR 789; cert. den. 313 U.S. 562 (1941).

[74] *Clarence J. Schoo*, 47 B.T.A. 459 (1942); *Arthur J. Hooks*, T.C. Memo. Dec., Dkt. 109416, 109427 (1944) par. 44,284 Prentice-Hall Memorandum T.C.; *Mary N. Crofoot*, T.C. Memo. Dec., Dkts. 3665, 4327 (1945) par. 45,036 Prentice-Hall Memorandum T.C. In the Schoo case, the court took the position that to apply the continuity of a proprietary interest doctrine in a recapitalization is to take it out of its setting, which here involved two corporations.

a. Pro-rata bond recapitalizations. As discussed in the preceding section, the recapitalization involved in the *Adams* and *Bazley* cases was one in which bonds were issued in exchange for common stock on a substantially pro-rata basis. Accompaniments of the exchange were the presence of earnings and profits available for distribution in an amount at least equal to the value of the bonds distributed, the existence of a closed corporation, the callable feature of the bonds in *Bazley*, and their essential equivalence to cash. In the absence of any one of these factors, a taxpayer could logically argue the inapplicability of these cases.

Another type of bond recapitalization might involve the issuance of bonds in exchange for preferred stock. In theory, there is no reason to assume that such an exchange would receive treatment any different from the *Adams* and *Bazley* exchanges, especially when the preferred stockholders accomplish the equivalent of a distribution of available earnings and profits.

Recapitalizations that involve the issuance of preferred stock in exchange for bonds were cited, prior to *Adams* and *Bazley*, and still are cited, by the regulations promulgated under the 1939 and 1954 IRC as one type of sanctioned recapitalization. Such a recapitalization certainly appears outside the ambit of those cases. It would seem that such cases would have no particular importance in a recapitalization where bonds were issued in exchange for outstanding bonds.

b. Non-pro-rata bond recapitalizations. The Adams and Bazley cases have been distinguished both in the Tax Court and the appellate court in cases where the bonds issued in the recapitalization were not held substantially pro rata by the common stockholders.

Thus, where a corporation had outstanding 5 per cent debenture shares, and class A and class B common stock, and a plan of reorganization was adopted pursuant to which new 5 per cent 20-year debenture bonds were issued to retire the class A stock and the debenture shares, and new common stock was issued to the holders of the class B stock, it was held that the exchanges of the debenture shares and class A stock for the debenture bonds were exchanges of stock and securities for securities pursuant to a plan of reorganization, in accordance with Section 112(b)(3).[76] Among the distinguishing features were:

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[75] *See Tarleau*, footnote 61, above; Platt, "Preferred Stock Dividends and Recapitalizations After the Bazley and Adams Cases." *Proceedings of New York University Seventh Annual Institute on Federal Taxation*, page 561. New York: Matthew Bender and Company, 1949.

[76] *The Wolf Envelope Company, et al.*, 17 T.C. 471 (1951), appeal dismissed (6 Cir. 1952), 197 F. 2d 864 (1952), 43 AFTR 112.

(1) the exchanges accomplished a purpose that could not have been carried out by an outright dividend of debentures because of the non-pro-rata ownership of the several classes of stock, and

(2) the debentures were not callable within ten years except in small amounts and by lot.

The purposes of the plan were to shift voting power from inactive stockholders to stockholders who were active in running the business and to reduce carrying charges ranking prior to the stock owned by active stockholders.

More recently, the Tax Court was presented with a fact situation involving an exchange of preferred stock for newly issued debentures,[77] which exchange it held to be distinguishable from Bazley and tax free under Sections 112(b)(3) and 112(g) of the 1939 Code. The Court found that the distribution of the debentures was not pro rata among common stockholders, the debentures were not readily marketable, and the corporation's purpose was to eliminate accumulated deficit represented by the unpaid dividends on the preferred stock.

The Fifth Circuit Court of Appeals affirmed a decision of the lower court involving an exchange of all the preferred stock of a corporation for new debenture bonds of the same par value, pursuant to Sections 112(b)(3) and (g)(1)(E) of the 1939 Code.[78] The Commissioner contended that the receipt of the debentures by the preferred stockholders should be taxed to them in the same manner as an ordinary dividend but the Court found no facts which would indicate that the plan of recapitalization was a scheme to misuse or misapply the reorganization exchange provisions to gain a tax advantage. The preferred stockholders gained no real advantage in making the exchange because both securities had the same market value, payment of dividends on the preferred was as reasonably assured as payment of interest on the debentures, and in the event of liquidation both the preferred stock and the debentures had the status of senior securities. The corporation had good business reasons for making the exchange in that the preferred stock could be redeemed only by paying a premium, whereas the debentures could be redeemed at par, and certain potential voting rights of the preferred were eliminated.[79]

c. Impact of 1954 Internal Revenue Code on bond recapitalizations. As indicated earlier in this chapter, there has been no change in the statutory provision that a recapitalization constitutes a reorganization. However, under Section 354(a)(2) a new limitation has been imposed upon the principal amount of securities (as distinguished from stock) which may be received without the recognition of gain. Generally, securities may be received tax free in a recapitalization (or other reorganization) in an amount not in excess of the securities surrendered in the exchange.

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[77] *Daisy Seide, et al.*, 18 T.C. 502 (1952).

[78] *Davis* v. *Penfield* (5 Cir. 1953), 205 F. 2d 798, 44 AFTR 151.

[79] For further discussion of the Wolf Envelope, Seide and Penfield cases, see Friedman, Wilbur H. and Silbert, Gerald, "The 'Continuity of Interest' Test in Bond for Stock Recapitalizations," *Proceedings of New York University Eleventh Annual Institute on Federal Taxation,* p. 361; New York, Matthew Bender and Company, 1953; ——— "Acquisition of Corporate Funds at Capital Gain Rates" *Proceedings of New York University Twelfth Annual Institute on Federal Taxation,* p. 215; New York, Matthew Bender and Company, 1954; also Tarleau, Thomas N., "Recapitalizations," *Proceedings of New York University Eleventh Annual Institute on Federal Taxation,* p. 371; New York, Matthew Bender and Company, 1953.

The new rule provides that if securities are received in a greater principal amount than the securities surrendered, then the fair market value of such excess shall be treated as "other property" ("boot") under Section 356(d). If no securities are surrendered, the excess shall be the entire principal amount of the securities received. Such boot is taxable as a dividend, if the distribution thereof has the effect of a dividend, to the extent of the accumulated earnings and profits; the remainder of the gain, if any, is treated as capital gain.[80]

The effect of the foregoing change in the law is that a recapitalization may be tax free to some of the participants therein while others may have gain recognized in an amount not in excess of the sum of the fair market value of the "boot" and money (if any) received. Each recapitalization is now required to be segmented into its taxable and nontaxable components.

d. Pro-rata preferred stock recapitalizations. Three types of recapitalization involving preferred stock have been said to be tax free. Thus, within the tax-free sanctuary fall recapitalization exchanges of: (1) preferred stock surrendered to a corporation for cancellation in exchange for no par value common stock; (2) preferred stock, previously authorized but unissued, issued for outstanding common stock; and (3) outstanding preferred stock, having certain priorities as to amount, time for dividend payments and distribution preferences upon liquidation, exchanged for a new issue of such corporation's common stock having no such rights.[81] Similarly, preferred stock issued in exchange for preferred stock in a recapitalization would not be within the *Adams* and *Bazley* rule. The tax consequences of a transaction, pursuant to which preferred stock is issued in exchange for part common or in which the common is turned in for new common and preferred stock, may be subject to some doubt.

If the transaction is cast in the form of a nontaxable stock dividend of preferred on common[82] or if the preferred is issued in exchange for part of the common incident to a tax-free recapitalization the common stockholders may, at some later date, sell all of the preferred stock previously received by them, to interests owning none of the common. If at still a later date, the preferred stock is redeemed by the corporation from the purchasers, the result of the varied transactions is that the common stockholders still retain their original proprietary and controlling interest in the corporation. To boot, they have the proceeds upon the purchase of their shares, which, it will be assumed, roughly approximates the earnings and profits paid out in redemption of the preferred from the purchasers. The net effect is that the earnings and profits have been siphoned from the corporation by the stockholders who have paid a tax at capital gain rates rather than a dividend tax. This is commonly referred to as a "bail out." A classic example of the bail out technique is *Chamberlin* v. *Commissioner.*[83]

In the *Chamberlin* case, Mr. and Mrs. Chamberlin owned approximately 85 per cent of the common stock of the corporation which had no other class of stock outstanding. The corporation possessed a large accumulated surplus and was in danger of the penalty surtax under old Section 102 (now Section 531).

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[80] 1954 IRC § 356(a)(2).

[81] Reg. 118, footnote 51, above, promulgated under the 1939 IRC.

[82] *Strassburger* v. *Commissioner*, 318 U.S. 604 (1943), 28 AFTR 650.

[83] 207 F. 2d 462 (6th Cir. 1953), cert. den. 3/8/54.

The taxpayer was in a high income tax bracket and so was not desirous of receiving a cash dividend. A deal was negotiated with insurance companies interested in purchasing preferred stock of the corporation. The corporation subsequently declared a preferred stock dividend to the taxpayer and his wife who, in turn, sold their preferred stock to the insurance companies. The latter surrendered the stock to the corporation for redemption. The Commissioner contended that the sale gave rise to ordinary dividend income and was upheld by the Tax Court.

The Court of Appeals reversed the Tax Court and held that the preferred stock dividend was nontaxable and that the sale of the preferred stock gave rise to capital gain. The effect of this decision was to legalize bail-outs. However, the 1954 Internal Revenue Code quickly closed the loophole created by the *Chamberlin* decision, as will be discussed below.[84]

e. Non-pro-rata preferred stock recapitalizations. Recapitalizations utilizing non-pro-rata distributions of preferred stock to effect a shift of corporate control have been upheld as tax-free by the Tax Court in *Elmer W. Hartzel*[85] and *Marjorie N. Dean.*[86] The pattern provides for the old or inactive group who control the corporation to exchange all of their old common stock for new preferred stock; the young or active stockholders exchange their old common stock for all of the new common stock.

Redemption of the preferred stock from the old or inactive stockholders would probably result in capital gain under the provisions of Section 302.[87] And the *Chamberlin* case would seem to portend the same result upon a sale of the preferred stock by the old or inactive group. But Congress responded to the *Chamberlin* decision by imposing limitations on the use of preferred stock (and certain other types of stock) as a means of withdrawing corporate earnings at capital gain rates. Such restrictions are contained in Section 306.

f. Impact of 1954 Internal Revenue Code on preferred stock recapitalizations. Under Section 306 of the new statute ordinary income treatment is accorded upon the disposition of certain kinds of stock issued as a dividend, or stock issued under such similar circumstances as to merit the same tax consequences. Such stock is termed "Section 306 stock." Briefly, Section 306 stock is preferred stock issued on or after June 22, 1954, whether in a corporate reorganization or otherwise, at a time when the distributing corporation has earnings or profits and under the circumstances of a stock dividend or a transaction having a substantially similar effect. Thus, stock dividend stock will generally be "Section 306" stock.[88] Stock received in a recapitalization (or other corporate reorganization or division) is Section 306 stock, if the effect is the same as the receipt of a stock dividend. Stock, the basis of which is determined by reference to the basis of 306 stock, is also Section 306 stock. How are recapitalizations using preferred stock affected by the foregoing provisions? Specifically, may the *Hartzel* and *Dean* type recapitalizations to shift corporate control continue to be implemented with certainty as to their tax consequences?

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[84] *See* the following section, "Impact of 1954 IRC on preferred stock recapitalizations."

[85] 40 B.T.A. 492 (1939), acq. 1939-2 C.B. 16.

[86] 10 T.C. 19 (1948), acq. 1949-1 C.B. 1.

[87] *See* discussion, above, under Section 3(d).

[88] There are three exceptions set forth in § 306(c).

It would appear that the preferred stock issued in exchange for common (to allow shifting of control in Hartzel and Dean situations) is not Section 306 stock. Stock received in a recapitalization (reorganization) is Section 306 stock only if the effect of the transaction was substantially the same as the receipt of a stock dividend or the stock was received in exchange for Section 306 stock. Neither circumstance prevails in the factual elements of such a recapitalization to shift control. The *Hartzel* and *Dean* cases would seem to remain with us as good law and are not overruled by the statute.

Recapitalizations also afford a possibility of ridding Section 306 stock of its taint. For example, common stock received in a reorganization cannot be Section 306 stock. Hence, it is possible to "downgrade" Section 306 stock by exchanging the same for common stock in a recapitalization. The common stock received would not be Section 306 stock.

In any event, even if the stock is received in a recapitalization in such a manner as to constitute Section 306 stock, the disposition thereof may nevertheless be excepted from ordinary income treatment in special cases, such as:[89] termination of a stockholder's interest (including the sale of an entire stock interest); liquidations (whether partial or complete); nonrecognition cases (query: are gifts excepted under this provision?); and transactions not in avoidance.[90]

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[89] 1954 IRC § 306(b).

[90] Proposed Regulations under the 1954 IRC covering Subchapter C, Sections 301 through 395 of the 1954 IRC, should be consulted for further reference.

12

The Election of an Unincorporated Enterprise to Be Taxed as a Corporation

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Section 1361—or Subchapter R—of the 1954 Code permits certain proprietorships and partnerships to elect to be taxed as corporations. As passed by the House, Subchapter R with its descriptive title "Election of Corporations, Proprietorships and Partnerships as to Taxable Status" consisted of two sections. Section 1351 permitted certain corporations to elect to be taxed as partnerships; Section 1361 in its turn permitted certain proprietorships and partnerships to be taxed as corporations. The net effect seemed to allow a considerable segment of commercial enterprises the choice of business form most suitable to their activities in addition to a choice of the lowest applicable tax rate. One decision presumably could be made without any reference to the other.

However, after Senate amendment, the law, as enacted, only Section 1361 survived. Thus, although certain proprietorships and partnerships may elect to be taxed as domestic corporations, the converse is not yet true.

1. Points to Consider

The principal points to be considered are as follows:

Section
General rules as to the election 2
Qualifications for the election 3
Corporate provisions applicable to an electing enterprise 4
Proprietor or partner of an electing enterprise ineligible for qualified pension or profit-sharing plan 5
Irrevocability of. the election 6
Constructive ownership 7
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2. General Rules as to Election

Section 1361 of the Internal Revenue Code of 1954 provides that certain proprietorships and partnerships may elect to be taxed as domestic corporations. The election is to be exercised not later than 60 days after the close of the first taxable year to which the election applies. This 60-day rule requires the election to be made prior to the return date for the filing of either partnership or individual tax returns.

The Treasury in T.D. 6124, issued on February 24, 1955, prescribed certain temporary rules,[1] providing the following procedure for making the election:

1. The filing of a statement within 60 days after the close of the proprietorship or partnership year to which the election is applicable. The statement shall establish the compliance of the electing enterprise with the qualifications set forth in section 1361(b). In addition the statement shall provide for the notification of the District Director with whom the election shall be filed in the event of change of 20 per cent or more in the interest in the capital and profits of the electing proprietor or partners in the enterprise, or if the enterprise should become a corporation.[2]

The statement requires the signature of the proprietor or *all* the partners owning any interest in the enterprise at *any* time during the over-all period. This time period begins with the first day of the taxable year for which the election is made, and ends on the day the election is filed. This requirement of joining in the election is equally applicable to those proprietors or partners who no longer hold any interest in the enterprise at the time of the election and to the proprietors or partners whose interest was acquired after the close of the taxable year affected by the election, but before the filing of the election.[3]

Contracts of purchase and sale of a business interest may now require an additional clause and bargaining point. Will the parties to the contract agree to join in the election and sign the statement as provided in T.D. 6124? It is interesting to note that these temporary rules give a veto power over the election to holders or former holders of minority interests. Even more interesting is the Treasury's implied departure from the ordinary tax concept that a proprietorship is in no way a continuing entity.

2. The election is confirmed by the filing of the income tax return by the electing enterprise on Form 1120.[4] This return must indicate its compliance with the regulations prescribed under Section 1361. Where the last day for the filing of the return (including any extensions of time) falls due before the last day of the third month following the month in which the regulations for Section 1361 are published in the Federal Register, the election is confirmed by filing an amended return, which shall contain the appropriate statement, in place of a return, on or before the last day of such third month.[5]

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[1] T.D. 6124, I.R.B. 1955-10, 34.

[2] Par. 23(b)(2), T.D. 6124, I.R.B. 1955-10, 34.

[3] *Ibid.*

[4] Par. 23(b)(1), T.D. 6124, I.R.B. 1955-10, 34.

[5] Par 23(b)(3), T.D. 6124, I.R.B. 1955-10, 35.

3. The statement or return (including any amended returns) is filed with the office of the District Director of Internal Revenue. However, these returns must be filed as though they were the returns of a corporation not that of an individual or partnership.[6]

3. Qualifications for the Election

The right to exercise the election is limited by a series of qualifications applicable to the enterprise and its owners at all times from the first day of the taxable year for which the election is made up to and including the date of the election.[7]

The first qualification is that of numbers. The electing enterprise may not be owned by more than 50 individual taxpayers.[8] Where one partnership is itself a member of an electing partnership, the number of individual partners in both firms is counted toward the application of this rule.[9] In all probability, the Internal Revenue Service will also number as individual partners the beneficiaries of any trust which holds a partnership interest in an electing firm. Since partners must be individuals, any firm in which a corporation owns a partnership interest, such as a joint venture, is not eligible to exercise the election.

Another restrictive "qualification" prohibits a business enterprise from exercising the election where the proprietor or a partner with more than a 10 per cent interest in capital or profits is either a proprietor or a partner with a like interest in another enterprise which has properly exercised its election to be taxed as a domestic corporation.[10]

Yet another statutory restriction provides that no proprietor or partner of an electing enterprise may be either a nonresident alien or a foreign partnership.[11]

The most important of all the "qualifications" provides that the electing enterprise must be one in which capital is a material income-producing factor, unless such enterprise obtains 50 per cent or more of its gross income from earnings, gains, or profits from the buying and selling of real estate, stock, securities, or commodities, either as a principal or broker for others.[12] Professional service proprietorships and firms—law, accounting, and the like—except for brokerage services, would be prohibited from exercising the election.

The qualification only requires that capital be "a material income-producing factor." The Senate Committee report gives only a sketchy definition in its statement, "Capital would be considered a material income-producing factor if the operation of the business required a substantial inventory or a substantial investment in plant, machinery or equipment." [13] All about this rule of thumb, there is an area of doubt which despite Regulations may require additional definition by Court decisions.

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[6] Par. 23(b)(4), T.D. 6124, I.R.B. 1955-10, 35; 1954 IRC § 6091(b).
[7] 1954 IRC § 1361(b).
[8] 1954 IRC § 1361(b)(1).
[9] Sen. Rep. No. 1622, 83rd Cong., 2nd Sess., 455-456 (1954).
[10] 1954 IRC § 1361(b)(2).
[11] 1954 IRC § 1361(b)(3).
[12] 1954 IRC § 1361(b)(4).
[13] Sen. Rep. No. 1622, above, 456.

4. Corporate Provisions Applicable to the Electing Enterprise

Consistently enough, Section 1361 provides in broad terms that an enterprise which elects to be taxed as a domestic corporation shall be considered as a corporation as to all other respects for the purposes of Subtitle A.[14] There are definite exceptions to the all inclusiveness of this general rule.

For one, proprietors and members of partnerships will continue to file and pay the requisite self-employment tax as if no election were ever made.[15] Inasmuch as the electing enterprise is a corporation for Subtitle A purposes only, the withholding provisions of Subtitle C are not applicable to the "salaries" paid to the proprietor or partners.

Furthermore, an electing enterprise is treated as a corporation insofar as Parts III and IV of Subchapter C which set forth the rules relating to the treatment of corporate organizations and reorganizations, and insolvency reorganization, respectively, only in two specific situations.[16]

1. Where property is contributed to the electing enterprise, the corporate provisions of these parts will apply if there is a recognizable gain or loss.[17] Section 351(b) requires the recognition of gain (or loss) where property other than securities is received. In a partnership, stock and securities would have to be assumed but presumably a gain would be recognized on the fair market value of property in addition to any money that was received.
2. Parts III and IV are also applicable to the organization of an enterprise where an election is made for its first taxable year.[18] The organization of a partnership or proprietorship would be treated as the formation of a corporation with the attendant requirements of control (as defined in Section 368(c)) if any transfer of property to the electing enterprise is to be tax free. Section 351(a) specifically states that "stock or securities issued for services shall not be considered as issued in return for property." A partner whose contribution to the firm would be the value of future services rather than capital might be liable for substantial taxable gain. Unless all partners contributed capital, it might be better tax planning to postpone the election until the next taxable year.

Within these prescribed limitations, the proprietor or partners of an electing enterprise are shareholders in proportion to their respective ownership interests.[19]

5. Proprietor or Partner of an Electing Enterprise Ineligible for Qualified Pension or Profit-Sharing Plan

An important limitation upon the electing enterprises is the denial to the proprietor or partners of the privilege of participating as an employee in any qualified pension and profit-sharing plans of the business.[20]

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[14] 1954 IRC § 1361(c).

[15] 1954 IRC §§ 1401-1403.

[16] 1954 IRC § 1361(m).

[17] 1954 IRC § 1361(m)(1).

[18] 1954 IRC § 1361(m)(2).

[19] *See* footnote 14, above.

[20] 1954 IRC § 1361(d).

Inasmuch as the benefits of participation in such qualified plans have often been urged as the reason for conducting business as a corporation, the exclusion of these particular corporate benefits would seemingly discourage many from seeking to exercise the election.

This is likely to be particularly true in the cases of proprietorships and partnerships that can arrange to be an association taxable as a corporation.[21] As the *Kinter* case[22] indicated, members of such an association could participate in a qualified pension (or profit-sharing) plan.

6. Irrevocability of the Election

An electing enterprise is irrevocably committed to its choice to be taxed as a domestic corporation both for itself and any successor until there is a change of ownership.[23] Change of ownership is defined as a transfer of 20 per cent or more interest in profits and capital from the electing proprietor or partners.[24] In any year in which such a transfer of interest occurs, there is an automatic termination of the election for that taxable year and the subsequent years. To continue to be taxable as a domestic corporation for such year as well as subsequent years, a new election must be made in the same way as the original election.

The Senate Committee report "sets forth the rule that in any year in which ownership of the proprietorship is changed, or the original electing partners no longer own more than 80 per cent of the partnership, the election is revoked." [25]

This interpretation may indicate a "loophole" in the 10 per cent restriction of interest which one electing enterprise may hold in another would be electing enterprise.[26] A proprietor or a partner in one electing enterprise can hold an interest in any number of other electing enterprises provided such ownership is 10 per cent or less in profits and capital. Once there is a valid election, nothing seems to prevent the acquisition of more than a 10 per cent interest by such proprietor or partner without causing any termination of the election.

7. Constructive Ownership

In determining when there is suffecent "change of ownership" to cause an automatic termination of the election, the attribution of ownership rules under Section 267(c) are applicable.[27] So ownership is attributed where "stock"—the proportionate interest in capital and profits[28]—is owned by or for a corporation, partnership, estate or trust in which the electing proprietor or partner has an interest as a shareholder, partner, or beneficiary or by or for the family of the electing proprietor or partner. Ownership is not attributed to stock owned directly or indirectly by a partner.

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[21] 1954 IRC § 7701(a)(3); 1939 IRC § 3797(a)(3).
[22] *U.S.* v. *Arthur R. Kinter* (9 Cir. 1954), 216 F. 2d 418.
[23] 1954 IRC § 1361(e).
[24] 1954 IRC § 1361(f).
[25] Sen. Rep. No. 1622, above, 457.
[26] *See* footnote 10, above.
[27] 1954 IRC § 1361(g).
[28] *See* footnote 14, above.

8. Imposition of Corporate Taxes

The electing enterprise is expressly subjected to three corporate taxes.[29]

1. Section 11: corporate normal and surtax.
2. Section 531: accumulated earnings tax.
3. Section 1201: alternative tax for capital gains.

9. Personal Holding Company Income

Income characterized as personal holding company income under Section 543 is excluded from the income of the electing enterprise which is taxed under corporate tax rates.[30] The excluded income is the taxable income of the proprietor or partners, the expenses attributable to such income are deductible only by such proprietor or partners.[31] Consequently, any subsequent distribution of such personal holding company income is not taxable as a corporate distribution to its stockholders, but is included in the income of the proprietor or partner.

Personal holding company income which is undistributed during the taxable year is treated as a contribution to the capital of the electing enterprise as of the close of the year in which it is earned.[32] There is a corresponding increase in the basis of the proprietor's or partner's interest in the electing enterprise.

In determining whether rents and royalties are included in personal holding company income, all the income of the electing enterprise including such personal holding company income is added together to compute the gross income of the enterprise for the taxable year.[33]

10. Computation of Taxable Income

Among the expenses which may be deducted from the gross income of the electing enterprise are the salaries of the proprietor and partners.[34] The deduction is allowable only where actual services are rendered. Here again, there will be all the problems of reasonable compensation of the corporation stockholder.

In addition, expenses properly allocable to the operation of the electing enterprise are allowable deductions.[35]

11. Distributions of Electing Enterprises

Any distribution by an electing enterprise other than a distribution of personal holding company income is treated as a corporate distribution under Parts I and

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[29] 1954 IRC § 1361(h).

[30] 1954 IRC § 1361(1). Income from brokerage commissions is not considered as personal holding company income.

[31] 1954 IRC § 1361(i)(2).

[32] 1954 IRC § 1361(i)(3).

[33] 1954 IRC § 1361(i)(4).

[34] 1954 IRC § 1361(j)(1).

[35] 1954 IRC § 1361(j)(2).

II of Subchapter C.[36] This includes liquidating distributions,[37] as well as other than liquidating distributions.[38]

Such distributions may be an ordinary dividend, a distribution in redemption of part or all of a proprietary or partnership interest, a distribution in redemption of such an interest to pay death taxes, a distribution in partial or complete liquidation of the enterprise. In the last case, there may be the problem of the collapsible corporation.

12. Advantages and Disadvantages of the Election

The benefits in making the election result from the income splitting between the electing enterprise and its owner or owners. The over-all tax of the corporate tax rates plus the individual taxes may be less than the former individual taxes imposed solely on the owner or owners. Such circumstances create the maximum tax benefits.

Conversely, if distributions are made by the electing enterprise to its shareholder or shareholders, the proprietor or partners, the combination of individual and corporate taxes may result in a greater over-all tax than was imposed prior to the election.

Subchapter R presents many problems which may or may not be resolved by the pending Treasury Regulations.

1. "Reasonable compensation" for partners or a sole proprietor.[39]
2. Taxation of distributions.
3. Will the automatic termination of the election create a distribution of accumulated earnings and profits[40] or will the failure to make another election constitute a partial or complete liquidation?
4. Is the incorporation of an electing enterprise a tax-free reorganization?[41]
5. Where a new election is required and is made forthwith, has the electing enterprise continued uninterrupted or is there a liquidating dividend?
6. Treatment of personal holding company distributions.

Use of the election will undoubtedly reveal other problems. Until the Treasury Regulations are issued, any discussion is largely speculative.

13. Conclusions

For the present there are few, if any, tenable conclusions. In any particular situation, the advisability of making the election can only be determined by the merits (or lack of them) for each individual enterprise.

With many potential problems (and few available answers), advising the taxpayer to make an irrevocable election cannot be generally recommended. For the present, and at least until the release of applicable Treasury Regulations, caution would be advisable. If the advantages of being taxed as a corporation are so compelling, why not organize as a corporation?

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[36] 1954 IRC § 1361(k) and (l).

[37] 1954 IRC § 1361(l).

[38] 1954 IRC § 1361(k). These problems are discussed in greater length in Chapter 10, "Corporate Distributions and Adjustments."

[39] *See* footnote 34, above.

[40] *See* footnote 37, above.

[41] *See* footnote 16, above.

Part III

BUSINESS ACCOUNTING

13

Major Differences Between Tax Accounting and Accepted Commercial Accounting Practices

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The 1939 Internal Revenue Code provided that "the net income shall be computed upon the taxpayer's annual accounting period . . . in accordance with the method regularly employed in keeping the books of such taxpayer . . ."[1] In interpreting this apparently simple requirement of the law, the Internal Revenue Service and the courts have evolved many accounting concepts for tax purposes that often differ considerably from the concepts accepted by public accountants and the business community as the proper bases for determining income.[2] In addition, legislation, sometimes intended to give special concessions to certain taxpayers, and sometimes intended to close loopholes or limit deductions, has also created special accounting concepts for tax purposes.

The 1954 Internal Revenue Code has, in some areas, attempted to narrow the differences between tax and commercial accounting concepts. However, in doing so, it has set up certain specific rules for the handling of certain income and expense items. Although these rules have the effect of bringing tax accounting rules closer together, differences still remain.

1. Points to Consider

To be able to appraise a client's business and tax problems and advise upon them properly, an awareness of the nature of these tax and commercial accounting differences is an obvious prerequisite. Furthermore, inasmuch as most of the 1954 Revenue Code changes in this area are elective with the taxpayer, a knowledge of the tax status of particular transactions under both the 1939 and 1954 Codes is necessary. The major areas of difference between tax and commercial accounting practices fall into these classifications:

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[1] 1939 IRC § 41. A somewhat similar provision is found in 1954 IRC § 446(a).

[2] Generally, tax practitioners have urged the necessity of equating tax accounting and commercial accounting practice. *See*, e.g., Jacquin D. Bierman and Richard S. Helstein, "Accounting for Prepaid Income and Estimated Expenses under the Internal Revenue Code of 1954," *Tax Law Review*, November, 1954, Vol. 10, page 83. For a cogent argument to the contrary, *see* Walter J. Blum, "Simplification of the Federal Income Tax Law," *Tax Law Review*, January, 1955, Vol. 10, page 243.

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2. Taxation of Unrestricted Income

The 1954 Code attempted to narrow the differences between commercial and tax accounting rules as they affect the reporting of prepaid income by offering the accrual basis taxpayer an election to spread such income over the period (not exceeding six years) in which it is earned.[3] However, the 84th Congress, at the request of the Treasury, repealed this provision of the Code retroactively to its original date of enactment.[4] The net effect of this action was to revert to the rules developed under the 1939 Code insofar as prepaid income is concerned.

Under the 1939 Code, income, the use of which is not restricted in the hands of the recipient, is taxable when received regardless of the possibility of subsequent repayment.[5] Nor, apparently, does it matter that the income has not yet been earned. Income that is usually categorized, for accounting purposes, as either "prepaid" or "deferred" is generally subject to taxation immediately under this "unrestricted use," or "claim of right," doctrine.[6]

Typical of the types of income affected by these rules is the receipt of amounts to be applied to the payment of future rents. These receipts are taxable when received, regardless of the landlord's method of accounting.[7] However, where the payment is made as a security of performance of the lessee's obligations under the lease, the payment is not considered advance rental, and hence, not subject to immediate taxation.[8] The courts look to the intentions of the parties to determine the true nature of the payment involved.[9]

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[3] 1954 IRC § 452.

[4] P.L. 74, 84th Congress.

[5] *U.S.* v. *Anderson*, 269 U.S. 422, 5 AFTR 5674 (1926); *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 10 AFTR 92 (1932).

[6] On the other hand, deductions attributable to the earning of this income are usually required to be spread over the period to which they apply. These advance payments are not deductible in full when made. *See*, e.g., G.C.M. 23587, 1943 C.B. 213 requiring the prorating of insurance premiums paid by cash basis taxpayers over the life of the policies.

[7] *Astor Holding Co.* v. *Commissioner*, 135 F. 2d 47 (5 Cir. 1943); Jack August, 17 T.C. 1165 (1952).

As in the case of advance rentals, amounts received without restriction for personal services constitute gross income immediately, regardless of the taxpayer's accounting method or obligations for future services. For example, a company was taxed on the proceeds of service coupons sold, although it had to render services in the future in honoring those coupons.[10] Similar results were obtained when a health club sold tickets which it later was required to honor,[11] and when an airline on the accrual basis sold tickets for future flights.[12] In one case, in what appeared to be an exception to the rule, the Tax Court allowed a warehouse company to defer the tax on part of its storage fees that were set aside to meet its agreement to remove without charge at the end of the storage period, the goods stored with it.[13] However, shortly thereafter, in a case presenting almost identical facts, the Tax Court reversed itself and insisted that the entire storage fee was taxable when received.[14] The earlier case was distinguished on the ground that in that case the practice involved was one of long standing. Thus, it would seem that any initial attempt by a company to follow the practice in question would fail for lack of previous similar treatment.

Where the recipient of the advance payment is merely a trustee of the funds, having to apply them for certain purposes only and having to refund any balance remaining after the required application, the courts have held that the receipts did not constitute taxable income when received.[15]

In addition to the trust situation, another exception to the general rule is found in the election extended to publishers who received subscription income. They are permitted to prorate this income over the life of the subscriptions, provided, however, that the costs of obtaining the subscriptions are similarly prorated.[16] However, this treatment is not permitted in the case of cash basis taxpayers.[17]

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[8] *Clinton Hotel Realty Corporation* v. *Commissioner* (5 Cir. 1942), 120 F. 2d 965; *John Mantell*, 17 T.C. 1143 (1952).

[9] Compare, for example, two recent cases, both handed down by the Tax Court on the same day: In *John Mantell*, 17 T.C. 1143 (1952), the lease referred to the tenant's payments as security for performance. The landlord was accountable for the money and was required to repay it if there was full performance by the lessee. In these circumstances, the court found for the taxpayer, holding the payments not to be taxable upon receipt despite the fact that the landlord had unrestricted use of the money until such time as he might have to repay it. Nor, did it bother the court that the manner of repayment provided for in the lease looked suspiciously like an application of advance rentals to the last months' rentals. The landlord's repayment of the security deposit was to be made over the last five months of the lease, in varying amounts, each monthly amount coinciding exactly with the amount of rent due under the lease for that month. In *Jack August*, 17 T.C. 1165 (1952), the lease originally referred to the payments involved as advance rentals. Once done, the damage, apparently, could not be undone. The Tax Court refused to consider a later amendment to the lease which attempted to denominate the payments as security deposits. The court was convinced that the true intention of the parties was reflected in the earlier version of the lease.

[10] *South Tacoma Motor Co.*, 3 T.C. 411 (1944).

[11] *Your Health Club, Inc.*, 4 T.C. 385 (1944).

[12] *National Airlines, Inc.*, 9 T.C. 159 (1947). But cf. *Bremerton-Tacoma Stages, Inc.* v. *Squire* (D.C. Wash. 1951), 94 F. Supp. 918, 40 AFTR 516, where a District Court in Washington allowed a bus company to defer tax on bus tickets sold in bulk to the Navy for use by its personnel and not yet used. Unused tickets were subject to full refund.

[13] *Tower Warehouse*, T.C. Memo. (1947).

[14] *Capital Warehouse Co., Inc.*, 9 T.C. 966 (1947), aff'd (8 Cir. 1948) 171 F. 2d 395, 37 AFTR 644.

[15] *The Seven-Up Company*, 14 T.C. 965 (1950); *Broadcast Measurement Bureau, Inc.*, 16 T.C. 988 (1951). For a case distinguishing between a trust situation and one where services are to be performed by the recipient, *see Krim-Ko Corporation*, 16 T.C. 31 (1951).

Where executory contracts were involved the Tax Court refused, in several cases, to apply the unrestricted income test. In one such case,[18] a coal dealer received deposits for future delivery of coal. There, the court refused to find immediate income, holding the contracts between the coal company and its customers to be executory at the end of the year, the cost of the coal to be delivered still unknown, and the eventual profit on the transactions impossible to calculate at that time. Subsequently, the Tax Court employed similar criteria in finding no taxable income to a cemetery company for deposits received in connection with the sale of space in a mausoleum to be built.[19] Until such time as the mausoleum had reached a certain stage of construction, either party could withdraw. At the end of the year in question the construction had not yet reached a stage where the contract was no longer executory, nor could the profits then be calculated.

It would appear from these cases that the courts adopted a "condition subsequent" test in dealing with executory contracts under the "unrestricted use" doctrine. If the court can say that the taxpayer is entitled to use the money now, although if certain events (such as his failure to perform, or the customer's exercise of his right to get refunds instead of the service contracted for) occur in the future he may have to repay it, then it apparently finds taxable income on the receipt of the advance payment. The events causing the repayment (the courts seem to reason) are conditions subsequent to the unfettered use of the money received and do not affect its taxability. However, if the court can say that the taxpayer is really not entitled to keep the money (although he has unrestricted use of it in the meantime) until certain events or performances occur, it apparently decides that no income arises at the time of the prepayment. The right to the income, reasons the court, is subject to the occurrence of conditions precedent. This distinction, it is submitted, is tenuous.

3. Payments Received Which Are Subsequently Repaid

a. Rule under 1939 Code. Once the unrestricted receipt was established as income when received, a repayment of all or part of the income in a subsequent tax year did not act to reduce the income in the year of receipt.[20] This often gave rise to this inequity: the income was taxed at high rates when received (because of the taxpayer's then high bracket or the high rates then prevailing, or both) and the deduction for the repayment in a subsequent year gave a lesser, if any, tax benefit (because of the taxpayer's then lower bracket, lower tax rates then prevailing, availability of other deductions, or any combination of these factors).

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[16] I.T. 3369, 1940-1 C.B. 46. But see *Beacon Publishing Co.* v. *Commissioner* (10 Cir. 1955), 218 F. 2d 697.

[17] *Booth Newspapers, Inc.*, 17 T.C. 294 (1951).

[18] *Veenstra & DeHaan Coal Co.*, 11 T.C. 964 (1948).

[19] *Woodlawn Park Cemetery Co.*, 16 T.C. 1067 (1951), acq. 1951-2 C.B. 4.

[20] *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 10 AFTR 92 (1932); *Burnet* v. *Sanford and Brooks Co.*, 282 U.S. 359, 9 AFTR 603 (1931).

The United States Supreme Court dealt with this question several times in recent years and always sustained the rule that a subsequent repayment did not reduce the income of the year in which the payment was originally received. Thus, in one case it refused to allow an employee to reduce the improperly computed bonus he received in a prior year by the amount he was required to repay to the employer in a later year.[21] And more recently, former employee-officers of insolvent corporations were required to pay deficiencies as transferees of the defunct corporations, the deficiencies arising from the disallowance, as unreasonable, of parts of salaries paid them in prior years. Yet the salaries were fully taxable when received by these employees. The payments as transferees could not be related back to the years when the salaries were received to reduce the income of those years.[22]

b. Rule under the 1954 Code. In attempting to correct the inequity of the rule as developed under the 1939 Code, the new law does not completely equate tax accounting with commercial accounting. In some cases it leaves the rule under the 1939 Code unchanged. In others it affords the taxpayer relief that can, in some cases, exceed the relief he would get by merely relating back the deduction to the year of income.

If the amount of the repayment does not exceed $3,000, the rules under the 1939 Code apply. For repayments that exceed $3,000, the taxpayer is given an alternative. He may choose to treat the repayment as a current deduction or he may reduce his current tax by the amount of tax he would have saved in the year he originally received the income he had to pay in the current year, had he been permitted to exclude such income in that prior year. If the amount of tax he would have saved in the prior year is more than his total current tax, he is entitled to a tax refund for the difference.[23]

The recipient of the repayment has also been given some relief in certain cases. Normally, he would have income in the year the repayment was made to him—presuming, of course, that he had the benefit of a tax deduction when he made the payment originally.[23a] However, if the payment originally was made because of a court decision in a patent infringement case and subsequently the court decision was reversed on the ground that such decision was induced by fraud or undue influence, he, therefore, having been repaid, has an option as to the treatment of the repayment. If the repayment amounts to $3,000 or more, he may either include that amount in income in the year of receipt or treat it as if never paid in the first instance. If the latter option is taken, the tax for the year in which the payment was originally made must be recomputed and the amount by which the recomputed tax exceeds the original tax for that previous year (plus interest) is added to the current year's tax.[23b]

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[21] *U.S.* v. *Lewis*, 340 U.S. 590, 39 AFTR 891 (1951).

[22] *Healy, et al.* v. *Commissioner*, 345 U.S. 278 (1953).

[23] 1954 IRC § 1341.

[23a] See Section 7c of this Chapter.

[23b] 1954 IRC § 1342, added by P.L. 384, 84th Congress (1955).

4. Provisions for Probable Expenses and Losses

Under accepted accounting principles, it is recognized as appropriate to provide for probable losses or expenses not yet realized.[24] For tax purposes, the general rule, as developed under the 1939 Code, seems to be that deductions are not allowed for reserves or accruals of expenses or losses that were deemed to be contingent.[25]

The 1954 Code attempted, as it did in the case of prepaid income, to cure the inequities that arose from the denial of deductions for estimated expenses under the 1939 Code by allowing such deductions where the taxpayer elected to follow prescribed procedures in setting up the necessary reserves.[26] However, this section met the same fate as did the section covering prepaid income—retroactive repeal.[27] Thus, here, too, the rules developed under the 1939 Code continue to govern.

The requirements for deduction of estimated costs were laid down by the United States Supreme Court in these words:

> It has never been questioned that a taxpayer who accounts on an accrual basis may, and should, deduct from gross income a liability which really accrues in the taxable year. It has long been held that in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid; . . .[28]

Although the courts and the government seem to agree that the above statement reflects the proper rule for the deductibility of the items in question, they do not always agree as to when the fact and the amount of the liability has been sufficiently established to warrant deductibility. Similar facts presented to different tribunals have brought forth varying and conflicting results.

In dealing with construction contractors', mining companies', and similar taxpayers' contractual obligations to restore properties to pre-existing conditions, the Second and Fourth Circuits arrived at opposite conclusions concerning the deductibility of estimated reserves for such expenses.[29] However, the differences between the two circuits might be reconciled on the basis that in one case the court was convinced that the liability for the estimated expense was "susceptible of estimate with reasonable accuracy in the tax year," whereas in the other case there is no indication that the court was presented with the basis for the computation of estimated expenses the taxpayer attempted to deduct.[30] The Tax Court in cases subsequent to the *Harrold* case has not clearly indicated whether it would follow the Fourth Circuit decision reversing its decision in that case. It has been able to find other grounds for distinguishing these subsequent cases from the *Harrold* case.[31]

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[24] *See* e.g., Restatement and Revision of Accounting Research Bulletins, Issued by the Committee on Accounting Procedure, pages 22 and 87. New York: American Institute of Accountants, 1953.

[25] *See* the cases cited in footnote 28, above.

[26] 1954 IRC § 462.

[27] P.L. 74, 84th Congress.

[28] *Dixie Pine Products Co.* v. *Commissioner*, 320 U.S. 516, 31 AFTR 956 (1944).

[29] Compare *Spencer, White and Prentis, Inc.* v. *Commissioner* (2 Cir. 1944), 144 F. 2d 45, 32 AFTR 1145, with *Harrold* v. *Commissioner* (4 Cir. 1951), 192 F. 2d 1002, 41 AFTR 442.

[30] In a subsequent case, *Central Cuba Sugar Company* v. *Commissioner* (2 Cir. 1952), 198 F. 2d 214, 42 AFTR 347, the Second Circuit cites the *Harrold* case with approval, indicating that that case stands for the proposition that a deduction is available "where the amount of the obligation and its final payment is so certain . . . [that] it would seem the height of business judgment and tax wisdom to establish a reserve and deduct the expense thus set aside in the year in which the related income accrues." In the same decision, the court indicates that its previous decision in the *Spencer, White and Prentis* case requires only an established liability.

The situation regarding vacation pay also had its areas of confusion. In *I.T. 3956*,[32] it was ruled that railroads could deduct accrued vacation pay, earned by the railroad's employees in the current year but not payable to them until the following year. Under a contract with the union, the railroad was required to give its employees from 6 to 12 working days of paid vacation in the year subsequent to the year in which the employees worked at least 160 days. The ruling allowed the railroad to accrue the vacation pay in the year an employee worked the 160 days. Apparently the government was satisfied with the *fact* that the liability existed, even though the vacation pay would not be payable if the employee's employment terminated at any time prior to the time he was scheduled actually to go on vacation. Nor did the government consider the amount of the liability insufficiently fixed, even though the accrual was based on the current wage scales of the employees involved and the actual vacation pay was to be computed on the wage scales in effect at the time the employee actually went on vacation. In a subsequent ruling,[33] a mining company was permitted to accrue up to the end of its fiscal year, where the period during which the employee had to earn his vacation with the requisite number of days of employment cut across two tax years of the employer. Yet, despite these two rulings, in a subsequent case, where the facts were substantially identical with those in the rulings, the Tax Court found the liability not fixed, and therefore not deductible, because the employees had to remain in the employ of the railroad up to the time they actually went on vacation in order to get the vacation pay. The possibility that they might not be so employed was sufficient to cause the court to call the liability contingent.[34]

Where the costs are dependent upon receipts, there is also disagreement in the courts on the proper tax treatment. In these cases, the actual expenses do not become due until the item of income is actually received. Nevertheless, the taxpayer, on the accrual basis, is required to report the income prior to receipt. This sort of situation usually arises where salesmen's commissions are dependent upon actual payment by the customer for the items purchased. In such case, the seller (the salesmen's employer) would, on the accrual basis, report the income in the year of sale. When, however, may he deduct the commissions to be paid to the salesmen on these sales?

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[31] *Ralph L. Patsch*, 19 T.C. 189 (1952); *J. E. Vincent*, 19 T.C. 501 (1952).

[32] 1949-1 C.B. 78. This I.T. was subsequently revoked in Rev. Rul. 54-608, 1954 I.R.B. No. 51 (page 5). The government has adopted the rule in the *Tennessee Consolidated Coal Co.* case and the other cases cited in footnote 34, below. However, the revocation of *I.T.* 3956 will apply only to years ending on or after June 30, 1955. (*See* Special Announcement, 1955 I.R.B. No. 6 (page 6).) The announced revocation was not intended to affect a taxpayer for years to which the 1954 Code applied if he availed himself of the election to take into account a reasonable addition to reserves for estimated expenses as provided for in 1954 IRC § 462. However, Section 462 was repealed retroactively to its date of original enactment. See footnote 25, above. To give taxpayers time to consider the effect of the repeal of Section 462 on their vacation pay tax treatment, the government subsequently announced that it would not apply Rev. Rul. 54-608 to years ending prior to December 31, 1955. Rev. Rul. 55-426, 1955 I.R.B. No. 26 (page 30).

[33] G.C.M. 25261, 1947-2 C.B. 44. This ruling, too, was modified by Rev. Rul. 54-608 to bring it into conformity with the government's new position on this deduction. *See* footnote 38, above.

[34] *Tennessee Consolidated Coal Co.*, 15 T.C. 424 (1950); *see also, Morrisdale Coal Mining Co.*, 19 T.C. 208 (1952); *Sheldon and Company* v. *Commissioner* (6 Cir. 1954), 214 F. 2d 655.

One court said the taxpayer could get the deduction only in the year that he actually received payment and thus became obligated to pay the commission.[35] More recent cases take a view more consistent with accepted accounting principles. These hold commissions deductible in the same year the sales were reported, holding that the expense was no more contingent than the income reported.[36] However, where there was a payment of the commissions before the accrual of the income, a deduction for the commission was disallowed. Only when the income was reported would the court allow the deduction.[37]

Deductions for contested taxes and other expenses have been subject to government interpretations that vary from commercial accounting concepts. From an accounting point of view a current deduction should be taken for taxes attributable to the current year's operations. This is true as well for tax accounting for accrual basis taxpayers. However, where the amount of taxes due (generally, state income, franchise, and similar taxes) is contested, no estimated amount of final liability is permitted as a deduction.[38] Apparently, here, both the fact and the amount of the liability have to be established as a basis for deduction. The government's position as to disputed taxes is apparently the following:[39]

1. If no payment was made, but instead the tax was contested, no deduction is allowed.[40]
2. If a contested tax was paid, it becomes deductible no later than the time of payment. It is immaterial that a claim or suit for refund was subsequently instituted.[41]
3. A deposit of taxes is sometimes a prerequisite to instituting a suit or an appeal relative to contested taxes. Such deposit is not regarded as a payment of the contested tax, and hence is not deductible.
4. Payments made to avoid penalties or interest—but not necessary as a prerequisite to instituting a suit or appeal—are treated as tax payments and are deductible in the year they are made.

For tax purposes, the treatment of contested expenses (other than taxes) is quite similar to the treatment of contested taxes. It is only when the liability is settled that the deduction is allowed. This result tends to thwart the accounting concept that revenues and expenses connected therewith should be matched, inasmuch as the year of settlement could be other than the year in which the liability was actually incurred.[42] Nonetheless, the tax decisions indicate that where liability was completely denied, no deduction could be taken.[43] Where there was a lawsuit in connection with the disputed cost and judgment was rendered which required the taxpayer to make payment, the deduction is allowed in the year of the judgment. Where there is an appeal, the deduction is not allowed until the judgment is affirmed.[44] However, the deduction can be taken upon payment, where payment is made while the appeal is pending.[45]

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[35] *Donnelly Corporation*, 22 B.T.A. 175 (1931).

[36] *Ohmer Register Co.* (6 Cir. 1942), 131 F. 2d 683, 30 AFTR 461; *Central Cuba Sugar Co.* v. *Commissioner* (2 Cir. 1952), 198 F. 2d 214, 42 AFTR 347.

[37] *The Shelby Sales Book Co.* v. *U.S.* (D.C. Ohio 1952), 104 F. Supp. 237, 41 AFTR 1260.

[38] *See Dixie Pine Products Co.* v. *Commissioner*, 320 U.S. 516, 31 AFTR 1214 (1944); *Western Cartridge Co.*, 11 T.C. 246 (1948); *Gunderson Bros. Engineering Corporation*, 16 T.C. 118 (1951); *Taylor Instrument Companies*, 14 T.C. 388 (1950); *A. H. Morse Co.*, T.C. Memo., 1952.

[39] G.C.M. 25298, 1947-2 C.B. 39.

[40] *See also, Great Island Holding Corporation*, 5 T.C. 150 (1950).

[41] *See also, Chestnut Securities Co.* v. *U.S.* (Ct. Cls. 1945), 62 F. Supp. 574, 34 AFTR 461.

Other areas where reasonable reserves for probable losses or expenses would ordinarily be provided for in accepted accounting practice but which are not allowed for tax accounting purposes, include:[46]

1. Anticipated expenses of restoring property by a lessee.[47]
2. Expected losses of collection agencies.[48]
3. Provision for redeeming sales slips with premiums.[49]
4. Self insurance reserves.[50]
5. Expected losses on executory contracts.[51]
6. Provisions for anticipated taking of cash discounts by customers.[52]
7. Reserves for expected returns of merchandise, cancellations, and allowances.[53]

5. Deductibility of Real Estate Taxes

When real estate is sold, an adjustment in the selling price is usually made to apportion the real estate tax between the buyer and seller. Each is charged, in effect, with the portion of the real estate tax applicable to the period of the real estate tax year in which he has title to the property, irrespective of which of the two (buyer or seller) actually pays the tax to the taxing authorities. For accounting purposes, this is a proper procedure.

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[42] The Court of Claims and one District Court have allowed the taxpayer in O.P.A. violation cases and in a renegotiation case to relate back expenses paid in a subsequent year when the controversy was settled to the year about which the controversy arose. *Hershey Creamery Co.* v. *U.S.* (Ct. Cls. 1952), 101 F. Supp. 877, 41 AFTR 570; *Marantz* v. *Yoke* (D.C., W. Va., 1953); *Holmes Projector Company* v. *U.S.* (Ct. Cls. 1952), 105 F. Supp. 690, 42 AFTR 404.

[43] *Bump Confectionery Co.*, 4 B.T.A. 50 (1926); *Hamler Coal Co.*, 4 B.T.A. 947 (1926).

[44] *See, Virginia Stage Lines, Inc.*, 16 T.C. 557 (1951).

[45] *Utica Knitting Co.* v. *Shaughnessy* (D.C., N.D. N.Y. 1951), 100 F. Supp. 245, 41 AFTR 116.

[46] Deduction is generally allowed only when the expense is actually paid or incurred. *Lucas* v. *American Code Co., Inc.*, 280 U.S. 445, 8 AFTR 10278 (1930); *Brown* v. *Helvering*, 291 U.S. 193, 13 AFTR 851 (1934); *Spring Canyon Coal Co.* v. *Commissioner* (10 Cir. 1930), 43 F. 2d 78, 9 AFTR 30; *Emporium Water Co.*, T.C. Memo., 1953; *Quality Roofing Co.*, 16 B.T.A. 1370 (1929); *Moloney Electric Co.*, B.T.A. Memorandum (1943); *Scholl Co.*, 30 B.T.A. 993 (1934); *Uvalde Co.*, 1 B.T.A. 932 (1925).

[47] *Belt Ry. Co. of Chicago* (D.C. Cir. 1930), 36 F. 2d 541, 8 AFTR 9875.

[48] *Commercial Liquidation Co.*, 16 B.T.A. 559 (1929).

[49] *O. J. Morrison Dept. Store*, 23 B.T.A. 895 (1931). But *see* Reg. 118, § 39.42-5 wherein the government allowed for the deduction of reasonable reserves for redemption of trading stamps and premium coupons.

[50] *Spring Canyon Coal Co.* v. *Commissioner*, 9 AFTR 30, 43 F. 2d 78 (10 Cir. 1930); *Pan-American Hide Co.*, 1 B.T.A. 1249 (1925); *Greenville Coal Co.*, 3 B.T.A. 1323 (1926); *Potts Run Coal Co.*, 19 B.T.A. 1; I.T. 1797, II-2 C.B. 100 (1923).

[51] *Moloney Electric Co.*, B.T.A. Memo. 1942; *American Fork and Hoe Co.*, T.C. Memo., 1943; *Atlas Mixed Mortar Co.*, 23 B.T.A. 245 (1931); *Clay Sewer Pipe Ass'n.* v. *Commissioner* (3 Cir. 1943), 139 F. 2d 130, 31 AFTR 1013.

[52] *Shapleigh Hardware Co.* v. *U.S.*, 81 F. 2d 697 (8 Cir. 1936), 17 AFTR 428; *Ederheimer-Stein Co.*, 2 B.T.A. 711 (1925); *American Cigar Co.*, 21 B.T.A. 464 (1930); G.C.M. 1343, VI-1 C.B. 177 (1927); I.T. 2342, VI-1 C.B. 178 (1927).

[53] *Covington Cotton Oil Co.*, 12 B.T.A. 1018 (1928); *W. S. Buck Mercantile Co.*, 6 B.T.A. 285 (1927); *Readers' Publishing Corp.*, v. *U.S.* (Ct. Cls. 1930), 40 F. 2d 145; 8 AFTR 10707; *M. C. Stockbridge*, 2 B.T.A. 327 (125).

Under the 1939 Code, there was an "all or nothing" rule. He who owned the property on the date the real estate tax liability became fixed got the deduction for the whole tax.[54]

The 1954 Code changed that rule. For tax years ending after 1953, but only in the case of sales after 1953, an apportionment of the tax between buyer and seller is required.[55] Also, for accrual basis taxpayers, an election to accrue real estate taxes ratably over the periods covered by those taxes is permitted.[56] Under the *Magruder* v. *Supplee* doctrine, the entire tax accrued on the date the tax liability became fixed.

6. Treatment of Treasury Stock Purchases and Resales

Accountants recognize no difference between the purchase and retirement of its own stock by a corporation with subsequent sale of previously unissued stock and the purchase of stock to be held as treasury stock and its subsequent resale.[57] Any gain on the latter transaction is not included in the company's income statement.[58] However, under the 1939 Code, the tax situation could be considerably different. The Regulations[59] stated:

> . . . if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in shares of another.

Thus, a corporation had to show its purpose for acquiring the treasury stock was to get additional capital. Any other purpose was apparently insufficient. For example, corporations were taxed on gain resulting from the resale of treasury stock to key employees—the stock being acquired for the express purpose of such resale.[60] Under the 1939 Code, to avoid a tax, corporations had to be slaves to form in such cases: buying the stock, retiring it, and then issuing previously unissued stock.

The 1954 law brings tax law into agreement with accepted commercial accounting concepts. No gain is recognized to a corporation on the receipt of money or other property in exchange for its own stock, including treasury stock.[61]

7. Special Legislative Concessions to Taxpayers

For various reasons of public policy, Congress has seen fit to give certain concessions to taxpayers. Many of these call for tax accounting treatment that varies from accepted accounting principles. Included in this category are tax-free exchanges, involuntary conversions, certain recoveries of expenses, capital gains, carry-over and carry-back losses, percentage and discovery depletion, amortization of emergency and grain facilities, and exempt interest income. Inasmuch as each of these items is covered fully in other chapters, they will be briefly mentioned here—with no attempt at detailed analysis—merely to indicate the variance between the tax accounting and commercial accounting treatment of each.

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[54] *Magruder* v. *Supplee,* 316 U.S. 394, 28 AFTR 325 (1942).

[55] 1954 IRC § 164(d).

[56] 1954 IRC § 461(c).

[57] Restatement and Revision of Accounting Research Bulletins, *op. cit.*, footnote 32 above, at pages 13 and 14.

[58] *Ibid.*, at page 64.

[59] Reg. 118, Sec. 39.22(a)-15.

[60] *Commissioner* v. *Batten, Barton, Durstine & Osborn, Inc.* (2 Cir. 1948), 171 F. 2d 474, 37 AFTR 661; *Commissioner* v. *Rollins Burdick Hunter Co.* (7 Cir. 1949), 171 F. 2d 698, 37 AFTR 1503.

[61] 1954 IRC § 1032.

a. Tax-free exchanges.[62] Gains and losses from exchanges of properties of like kind and from various exchanges in connection with organization and reorganization of businesses can escape recognition for tax purposes. Many of these exchanges, for accounting purposes, would require recognition of gain or loss.

b. Involuntary conversions.[63] A gain or loss resulting from a condemnation award or from insurance proceeds in compensation for a casualty loss are recognized for accounting purposes. For tax purposes, a loss is recognized. A gain, where certain conditions as to reinvestment into similar property are met, can escape immediate recognition. However, the basis of the property involuntarily converted is carried over as the basis of the new property acquired. So the recognition of the gain is, in effect, postponed.

c. Tax benefit rule.[64] Accountingwise, a recovery of a debt previously charged off as bad would give rise to income directly or indirectly. (Where the reserve method is used, a recovery would increase the reserve, requiring a correspondingly smaller addition in the current year, thereby indirectly increasing current income or reducing current losses.) Similarly, a recovery of a previously paid tax or penalty in connection with a tax would be recognized. However, for tax purposes, such recoveries give rise to income only to the extent that the tax deductions claimed for the expenses which have now been recovered reduced taxable income in the year in which they were claimed. For example, if these expenses were claimed in a year in which the taxpayer had a net loss, to the extent that these expenses were not necessary in order for the loss to arise, they are not taxable when recovered.

d. Taxation of capital gains. For accounting purposes, the treatment of gains or losses resulting from the sale of capital assets and land or depreciable property held in a trade or business does not depend on the length of time the property was held before sale. For tax purposes, the holding period is of special significance. Special tax rates apply to gains on these properties if they were held more than six months before sale.[65] In addition, in the case of land or depreciable property held in a trade or business for more than six months, losses, too, get special beneficial treatment.[66]

e. Carry-over and carry-back losses. The tax law[67] allows business losses and losses resulting from casualties to be carried back two years and carried forward five years from the year of the loss to offset gains in those years. Accounting practice, of course, makes no similar provision for such averaging of income.

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[62] 1954 IRC §§ 1031, 1032, 1036; 1939 IRC § 112(b).

[63] 1954 IRC § 1033; 1939 IRC § 112(f); *see also* 1939 IRC § 112(n)—as to involuntary conversion of a residence.

[64] 1954 IRC § 111; 1939 IRC § 22(b)(12).

[65] 1954 IRC §§ 1201, 1202, 1231; 1939 IRC § 117(b), (c), and (j); § 23(ee).

[66] 1954 IRC § 1231; 1939 IRC § 117(j).

[67] 1954 IRC § 172; 1939 IRC §§ 122, 23(s).

Capital losses, too, get a special treatment in the tax law. Individuals may apply only up to $1,000 of net capital losses against their ordinary income. Any remaining capital loss may be carried forward for five years to be applied against capital gains and, up to $1,000 a year, against ordinary income. Corporations may not apply capital losses against other income. But, they, too, have a five-year carry-forward of these losses that may be applied to offset subsequent capital gains.[68]

f. Percentage and discovery depletion. Accountants recognize that the value of an investment in a mine, oil well, or other natural deposit decreases as the ore or oil is extracted. Thus, as the deposit is depleted an apportioned part of the investment is charged against the current income from the ore or oil extracted. This depletion charge is generally arrived at, for accounting purposes, by dividing the estimated total number of units to be extracted into the investment and multiplying the result by the number of units extracted. For tax purposes, however, for certain minerals, an arbitrary percentage of gross income is allowed as a depletion deduction in lieu of the depletion deduction computed by the conventional method.[69] In some cases, too, under the 1939 Code, the fair market value, rather than cost, could be used as the basis on which to compute the depletion deduction.[70]

g. Amortization of emergency and grain facilities. To encourage building of facilities to help in the war effort, Congress, during World War II and the Korean conflict, allowed the cost of these facilities to be deducted over a 60-month period, rather than the longer useful life of these facilities.[71] Recently, Congress extended this speeded up amortization to certain grain storage facilities.[72] Of course, such speeded up amortization conflicts with the accounting concept that the cost of fixed assets be recovered—via depreciation charges—over the useful life of the asset.

h. Exempt interest income. Accountants recognize interest received as income. So does the tax law. However, interest on obligations of states, municipalities, territories, and the District of Columbia are exempt from federal income tax. Many obligations of the United States and its instrumentalities were tax exempt if issued before March 1, 1941.[73]

8. Restricting Legislation

Just as the legislation that grants concessions to taxpayers causes tax accounting to vary from accepted accounting standards, so, too, does some restricting legislation. The legislation in this category either limits the amount of deductions or attempts to close loopholes in the tax structure. Here, too, the items will be touched upon but briefly because of their fuller treatment in other chapters of this book.

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[68] 1954 IRC §§ 1211, 1212; 1939 IRC § 117(d), (e).

[69] 1954 IRC § 613(b); 1939 IRC § 114(b)(3), (4).

[70] 1939 IRC § 114(b)(2).

[71] 1954 IRC § 168(e); 1939 IRC § 124A.

[72] 1954 IRC § 169; 1939 IRC § 124B.

[73] 1954 IRC § 103; 1939 IRC § 22(b)(4).

a. Limitations on deductions. Inasmuch as accounting principles do not call for the consideration of the amount involved in determining deductibility of an item, any arbitrary limit set on the amount of deduction allowed (without regard to the bona fides of the item) automatically conflicts with good accounting practice. However that may be, the tax law does impose limitations on certain deductions. An individuals' deductions for contributions to charitable and like organizations in one taxable year is limited to a certain percentage of his adjusted gross income;[74] a corporation is limited to 5 per cent of its net income.[75] Medical expenses are deductible only to the extent that they exceed a certain percentage of adjusted gross income (with certain exceptions for those over 65) and then, in addition, may not exceed amounts set out in the law.[76] Business losses of an individual may not exceed $50,000 a year if such losses occur in five consecutive years.[77]

b. Loophole closing limitations. For accounting purposes, losses on security wash sales are recognized. Not so for tax purposes. Where substantially identical securities are bought within 30 days before or after a sale at a loss, the loss is not recognized.[78]

Accountants are usually not concerned with family relationships in recognizing losses or accruing expenses. The tax law is so concerned. Losses on sales to certain enumerated relatives or between certain related businesses are not recognized.[79] Nor are accrued expenses deductible when payable to these related individuals or groups unless paid within 2½ months after the close of the taxpayer's tax year.[80]

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[74] 1954 IRC § 170(b); 1939 IRC § 23(o).

[75] 1954 IRC § 170(b)(2); 1939 IRC § 23(q).

[76] 1954 IRC § 213; 1939 IRC § 23(x).

[77] 1954 IRC § 270; 1939 IRC § 130(a).

[78] 1954 IRC § 1091; 1939 IRC § 118.

[79] 1954 IRC § 267; 1939 IRC § 24(b).

[80] 1954 IRC § 267(a)(2); 1939 IRC § 24(c).

14

Accounting for Income

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1. Points to Consider

Unpredictable contingencies often play havoc with the customary rules employed in accounting for income for tax purposes. Some contingencies postpone taxable income; others don't. The legislative and judicial jig-saws have carved out countless pieces for the tax man to assemble. Tracing some of the resultant patterns may prove useful to the practitioner who will inevitably encounter contingencies in the course of his daily work.

In planning or computing taxable income, certain typical situations are bound to arise sooner or later:

Section

How to decide the taxable year of disputed income items 2
How the "claim of right" can tax your receipts 3
How to avoid a tax on questionable compensation or other income 4
How to get a deduction for repayment of excessive income 5
When the tax applies to unclaimed amounts due customers 6
How to avoid some pitfalls in taxation of containers used in the sale of merchandise 7
How to handle prepaid income 8
How dealers can postpone taxation of reserves for financed sales .. 9

2. How to Decide the Taxable Year of Disputed Income Items

Statement of the Rule and the Exception.

The Rule

Uncollected income which is the subject of any important contest, dispute or controversy does not become taxable until such time as the differences are resolved.[1]

The Exception

The taxability of income is not postponed, however, if there is a reasonable expectancy that the right to income will be converted into money or its equivalent.[2]

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[1] *United States* v. *Safety Car Heating & Lighting Co.*, 297 U.S. 88, 16 AFTR 1311 (1936).

[2] *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290, 11 AFTR 4 (1932); *Automobile Insurance Co. of Hartford, Conn.* v. *Commissioner* (2 Cir. 1934), 72 F. 2d 265, 14 AFTR 424.

This doctrine, gleaned from the welter of court decisions that have been poured forth over the years, is easier stated than applied.

Situations under this heading will generally arise only where the taxpayer is on the accrual basis of accounting. Cash-basis taxpayers, of course, report income generally only when received.

Litigation. Whether initiated by the taxpayer or by his alleged debtor, litigation necessary to decide if the taxpayer is entitled to income, will usually defer the time for its taxation.[3] Where there is a serious controversy which bears upon the taxpayer's right to the income, the termination of the legal proceedings will generally be the date of accrual.[4] The Supreme Court, speaking through Justice Cardozo, in a case relating to a claim for patent infringement, has said:[5]

> Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital, not the potency of fruition. With few exceptions, if any, it is income as the word is known in the common speech of men. . . . When it is that, it may be taxed, though it was in the making long before.

When litigation is terminated. Once litigation has been commenced, it can be concluded only by a binding settlement or a final judgment. The judgment of a lower court or of any court except the court of last resort is not deemed to be a termination of the litigation.[6] The final judgment of the highest appellate court having jurisdiction over the dispute is essential to its resolution. Similarly conclusive is the date on which the period for filing an appeal expires.[7] This suggests in certain instances the advisability of entering into a settlement agreement a year prior to the one in which falls the appeal expiration date, since accrual of income in the earlier year may be dictated by tax considerations.[8]

Unlitigated contests. It is not essential to the postponement of income that the dispute be the subject of a legal action. If the claimed debtor denies liability, this will normally prevent the accrual of income. If the parties are contesting the title to income-producing securities, for example, no income is deemed received by either until the underlying question is settled, provided the income is held either in a joint account or recorded by the recipient in a suspense account.[9]

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[3] *United States* v. *Safety Car Heating & Lighting Co.*, footnote 1 above; *Slider, Inc.*, 5 T.C. 263 (1945).

[4] *London-Butte Gold Mines Co.* v. *Commissioner* (10 Cir. 1940), 116 F. 2d 478, 26 AFTR 164; *Cold Metal Process Co.*, 17 T.C. 916 (1951), affirmed without opinion (6 Cir. 1952) 1952 Prentice-Hall Fed. Tax Service, ¶ 71,096, ¶ 71,156.

[5] *United States* v. *Safety Car Heating & Lighting Co.*, above, footnote 1.

[6] But *see North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 11 AFTR 16 (1932), and discussion below of situations where payment is received although appeal is taken.

[7] In *H. Liebes & Co.* v. *Commissioner* (9 Cir. 1937), 90 F. 2d 932, 19 AFTR 965, this subject is thoroughly analyzed and the court says in part:

> "It is clear that where a claim exists, no income may accrue, in the absence of a settlement, so long as a judgment has not been entered. . . . Approaching the other end of the process of litigation, we have for consideration the case where the claim has been reduced to judgment but an appeal has been taken. *United States* v. *Safety Car Heating & Lighting Co.* . . . we believe establishes the rule, namely, that no income accrues until the appeal is determined . . .
>
> "As to the situation lying between the two mentioned, that is where judgment is entered, and no appeal has been taken, but the time within which an appeal might be taken has not expired, we find no cases directly in point. If appeal is taken, the right is not fixed until determination of the appeal, and if no appeal is taken, the right is fixed. We believe in the latter situation that the right becomes fixed on termination of the appeal time."

[8] *Richards Estate* v. *Commissioner* (2 Cir. 1945), 150 F. 2d 837, 34 AFTR 102.

[9] *Jacob M. Eisenberg Estate*, 6 T.C.M. 771 (1947).

In situations where no litigation occurs, the dispute is at an end when the parties have reached a mutual agreement.[10]

Uncertainty as to amount. Uncertainty as to amount may be a vital factor in a contested income situation. If the amount is not reasonably ascertainable, if the differences concern questions of legality of a high degree, the contest may result in deferring income.[11]

On the other hand, the intervention of some legal procedure[12] or even a failure to achieve some accord as to the amount of liability[13] will not necessarily be decisive in staving off the accrual. The courts appear to have extended this theory quite far in a number of instances, predicating their decisions on the ground that an amount may be "unknown but not unknowable." This rationale is persuasive and appealing. The test is objective (ascertainability), rather than subjective (ascertainment).

Exception to the general rule. Woven into the general rule is an important exception which has been stated as follows:[14]

> . . . income accrues to a taxpayer, when there arises to him a fixed or unconditional right to receive it, if there is a reasonable expectancy that the right will be converted into money or its equivalent.

If a right to income is granted by legislation, the "ministerial" function of a government agency in processing the award does not bar accrual.[15] The settlement of a litigated controversy establishes the right to income, despite the continuance of the proceeding to insure the performance of certain acts pursuant to the settlement agreement.[16]

The existence of an unpaid claim for damages at the end of the taxable year can constitute income where all of the *events* have occurred which fix not only the liability but also the amount.[17] Here again, the decisive factor is the actual occurrence of events, an objective test, as contrasted with the possibilities for manipulation inherent in so-called "settlements" under controlled conditions.[18]

The test seems to be whether, in the light of past events, it was possible to ascertain the fact that income would be received as a result of events that occurred before the year-end as well as the amount of such income.[19] The weight of authority, therefore, operates in a sense, to hold open the taxable year until an accurate picture of exactly what transpired is developed in the bright light of retrospection.

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[10] *See Wells* v. *United States* (Ct. Cls. 1946), 64 F. Supp. 476, 34 AFTR 990.

[11] *Boston Elevated Railway Co.*, 16 T.C. 1084 (1951), this issue not appealed; *Luckenbach Steamship Co.*, 9 T.C. 662 (1947); *Henry Hess Co.*, 16 T.C. 1363 (1951), affirmed on this issue 210 F. 2d 553, 45 AFTR 358 (9 Cir. 1954); *Foster Wheeler Corp.*, 20 T.C. 15 (1953)(A).

[12] *Continental Tie & Lumber Co.* v. *United States*, above, footnote 2.

[13] *Brown* v. *Commissioner* (2 Cir. 1944), 141 F. 2d 307, 32 AFTR 373, cert. den. 323 U.S. 714.

[14] *H. Liebes & Co.* v. *Commissioner*, above, footnote 7.

[15] *Continental Tie & Lumber Co.* v. *U.S.*, above, footnote 2; *Cramp Shipbuilding Co.*, 17 T.C. 516 (1951), affirmed sub nom. *Commissioner* v. *Ripley & Co., Inc.* (3 Cir. 1953), 202 F. 2d 280, 43 AFTR 405, where the court said:

> "We do not read the decisions as requiring irrevocability of the right to payment to support the realization of taxable income."

[16] *Lamm Lumber Co.*, 45 B.T.A. 1 (1941), affirmed (9 cir. 1943) 133 F. 2d 433, 30 AFTR 918.

[17] *Rite-Way Products, Inc.*, 12 T.C. 475 (1949) (A, C.B. 1949-2, 3).

[18] *Automobile Insurance Co. of Hartford, Conn.* v. *Commissioner*, above, footnote 2; *Lehigh Valley R.R. Co.*, 12 T.C. 977 (1949) (A, C.B. 1949-2, 2); *New Hampshire Fire Insurance Co.*, 2 T.C. 708 (1943) (N.A., C.B. 1944, 45), affirmed on other issue 146 F. 2d 697, 33 AFTR 426: I.T. 3961 (C.B. 1949-2, 35).

3. How the "Claim of Right" Can Tax Your Receipts

As long ago as 1932, the Supreme Court enunciated the "claim of right" doctrine in *North American Oil Consolidated* v. *Burnet* as follows:[20]

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

This principle has successfully withstood many determined assaults since first being expressed in these words by Justice Brandeis and stands today virtually unimpaired.[21]

Thus, if a taxpayer actually receives a sum of money as the result of a judgment handed down by a court, the amount is income when received, although subject to repayment, should the judgment be reversed upon appeal.[22]

The requirements of the doctrine are illustrated by two cases involving similar situations. In one, the manufacturer of a beverage was held not taxable on the unexpended portion of amounts received from its franchised bottlers to be devoted to national advertising.[23] Under the facts, the manufacturer was held to be merely a "conduit" between the bottlers and the advertising agency and the monies collected on behalf of the agency constituted a "trust fund." In the other, likewise involving a soft-drink company, an opposite result was reached because the documents failed to impose the same restrictions upon the use of the funds collected from the bottlers.[24] In other words, in the latter case, the absence of sufficient restrictions was equivalent to receipt under a claim of right.

Occasionally, the performance of a particular act can be crucial in giving rise to income.[25]

Embezzlement: the closing door. Although few practitioners have occasion to represent embezzlers, *Commissioner* v. *Wilcox*[26] is important because it delineated the boundaries of the claim of right doctrine. Contrary to the contentions of many taxpayers, the *Wilcox* case did not circumscribe or limit the claim of right doctrine. It merely decided that the fruits of embezzlement were not received *under a claim of right*. The Supreme Court, in fact, reiterated that—

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[19] *Brown* v. *Commissioner*, above, footnote 13.

[20] 286 U.S. 417, 11 AFTR 16 (1932).

[21] *Commissioner* v. *Alamitos Land Co.* (9 Cir. 1940), 112 F. 2d 648, 25 AFTR 261, cert. den. 311 U.S. 679; *United States* v. *Lewis*, 340 U.S. 590, 40 AFTR 258 (1951) (discussed at length below); *Est. of Mary G. Gordon*, 17 T.C. 427 (1951), affirmed (6 Cir. 1952) 202 F. 2d 171, 43 AFTR 144.

[22] This was the issue in *North American Oil Consolidated* v. *Burnet*, above, footnote 20. It is distinguishable from cases where *no payment* is made pending appeal (*see* footnote 6, above).

[23] *Seven-Up Co.*, 14 T.C. 965 (1950); followed in *Broadcast Measurement Bureau, Inc.*, 16 T.C. 988 (1951).

[24] *Krim-Ko Corp.*, 16 T.C. 31 (1951) (A) 1951-1 C.B. 2.

[25] In *National Metropolitan Bank* v. *United States* (Ct. Cls. 1953) 111 F. Supp. 422, 43 AFTR 802, the decedent had purchased a business from his mother under a contract providing that if he predeceased her, the entire business and all its assets would become hers. The Court held, surprisingly, that profits undrawn at date of death were not income to decedent or his estate.

[26] 327 U.S. 404, 34 AFTR 811 (1946).

> . . . a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain.

In the case of embezzlement, said the Court, the liability for repayment exists at the inception. There is a debtor-creditor relationship. The fact that the money is acquired by a wrongful or illegal act does not change the rules. "Moral turpitude is not a touchstone of taxability."

The mere presence of wrongful conduct, on the other hand, is not a "touchstone" of immunity from tax. In the period following the *Wilcox* decision, many taxpayers unashamedly sought classification as embezzlers as a sort of income tax haven. But a swindler was held liable for a tax upon his income from swindling.[27] The same was true of one who received illegal "kickbacks," even though he was later compelled to compensate his employer for fraud.[28]

A sales manager billed his employer for the services of a fictitious engineer while he actually rendered the engineering services himself. The payment he received was held taxable as compensation for services actually rendered and not exempt as the proceeds of embezzlement.[29] The same result was reached in the case of an employee of a wholesale grocery company who counterfeited sugar ration stamps and pocketed the over-ceiling-price proceeds from the sale of black market sugar.[30] This did not meet the statutory definition of embezzlement.

The rush to don the mantle of the embezzler reached perhaps its zenith in the instance of the principal stockholder in a close corporation who diverted to his personal use the proceeds of corporation cash sales and then pleaded for tax exemption on the ground that he was an embezzler. The courts held him to be taxable as the recipient of a constructive dividend.[31]

Finally, in *Rutkin* v. *U.S.*,[32] the Supreme Court spoke, narrowing to a slit the opening through which embezzlers could crawl. The Court refused to permit an extortionist to hide from the tax collector behind the *Wilcox* doctrine, which it limited to situations where embezzlement could be clearly spelled out. In the *Rutkin* case, therefore, the element of *consent* was sufficient to rule out the embezzlement "exemption," although the Court recognized that this consent was "induced solely by harassing demands and threats of violence."

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[27] *Akers* v. *Scofield* (5 Cir. 1948), 167 F. 2d 718, 36 AFTR 981, cert. den. 335 U.S. 823 (involving the proceeds from a fantastic "treasure hunt" in which the victim invested $272,000); *Henry C. Boucher*, 18 T.C. 710 (1952) (holding an employee taxable upon the fruits of a conspiracy with a supplier to defraud his employer).

[28] *Caldwell* v. *Commissioner* (5 Cir. 1943), 135 F. 2d 488, 31 AFTR 7.

[29] *Dahne W. Winebrenner*, 6 T.C.M. 1315 (1947).

[30] *Wallace H. Petit*, 10 T.C. 1253 (1948).

[31] *Currier* v. *United States* (1 Cir. 1948), 166 F. 2d 346, 36 AFTR 775. (All of the corporate stock was in the name of the taxpayer and his wife.) *See Kann* v. *Commissioner* (3 Cir. 1953) 210 F. 2d 247, cert. den. May 17, 1954, to the same effect. *See also Fleischer* v. *Commissioner* (8 Cir. 1946), 158 F. 2d 42, 35 AFTR 354, where, although the disallowance of salaries gave rise to a corporate deficit, the salaries were held income to the officer-stockholders instead of the return of capital or the proceeds of embezzlement. They were not, said the court, "picking the pockets of their corporation."

[32] 343 U.S. 130, 72 S. Ct. 571 (1952) (a criminal case relating to a payment of $250,000 received by a member of a bootlegging venture from one of his former partners subsequent to dissolution of the venture).

> "An unlawful gain, as well as a lawful one, constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value. . . .
>
> ". . . There is no adequate reason why assailable unlawful gains should be treated differently in this respect from assailable lawful gains. Certainly, there is no reason for treating them more leniently."

See Joseph Nitto Estate, 13 T.C. 858 (1949).

The subject of embezzlement should not be left without some mention of the possibility that the fruits of embezzlement, while initially exempt, may become taxable at a later date in the event that the indebtedness is condoned or forgiven by the victim.[33]

4. How to Avoid a Tax on Questionable Compensation or Other Income

The Lewis case. In *United States* v. *Lewis*,[34] the Supreme Court in 1951 reaffirmed the vigor of the old claim of right doctrine. In 1944 the general manager of a corporation collected a bonus of about $22,000, representing 10 per cent of corporate net profit *before* income taxes. Subsequent litigation determined in 1945 that the bonus should have been based upon net profit *after* taxes. In 1946, Lewis repaid about $11,000 to his employer and filed a claim for refund of that portion of his 1944 income tax paid because of his "mistake."

The Supreme Court found that the 1944 bonus was received under a claim of right and, adverting to its opinion in *North American Consolidated* v. *Burnet*,[35] said:

> Nothing in this language permits an exception merely because a taxpayer is "mistaken" as to the validity of his claim.

This, together with the oft-repeated tax axiom, borrowed from *Burnet* v. *Sanford & Brooks Co.*,[36] and restated in the following language, sealed the *Lewis* decision:

> Income taxes must be paid on income earned (or accrued) during an annual accounting period. The "claim of right" interpretation has long been used to give finality to that period, and is now deeply rooted in the federal tax system.

The *Lewis* decision swept away practically all the confusion previously surrounding "mistake" situations. Overthrown was the rule, developed principally by the Court of Claims, to the effect that the government's retention of the tax paid on the excessive income later repaid was "essentially unjust." [37] The honest taxpayer, stoutly asserted the Court of Claims, was entitled to as much consideration as the embezzler. These sentiments were later echoed by Justice Douglas in his dissent in the *Lewis* case.[38]

Although the taxpayer in the *Lewis* case, appeared to be on the cash basis, no different rule should obtain in the case of an accrual basis taxpayer.

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[33] G.C.M. 24945 (C.B. 1946-2, 27).

[34] 340 U.S. 590, 40 AFTR 258 (1951).

[35] 286 U.S. 417, 11 AFTR 16 (1932).

[36] 282 U.S. 359, 9 AFTR 603 (1931).

[37] *Greenwald* v. *United States* (Ct. Cls. 1944), 57 F. Supp. 569, 32 AFTR 1580; *Gargaro* v. *United States* (Ct. Cls. 1947), 73 F. Supp. 973, 36 AFTR 315 (Ct. Cls. 1949), 86 F. Supp. 840, 38 AFTR 912.

[38] "Many inequities are inherent in the income tax. We multiply them needlessly by nice distinctions which have no place in the practical administration of the law."

Implicit in the rationale of the *Lewis* decision was the conclusion that the repayment of excessive compensation constituted a deduction in the year of restitution.[39] The harsh effect of this, however, has since been mitigated by the 1954 Code.[40]

5. How to Get a Deduction for Repayment of Excessive Income

This problem arises most frequently in cases where a stockholder receives from a closely held corporation compensation, rent, or some other item of corporate expense. Subsequently, some part of the amount paid to the stockholder is disallowed as unreasonable or excessive by the Internal Revenue Service. If he refunds to the corporation the amount determined to be unreasonable, is he nevertheless taxable on the original amount received?

Pre-1954 rule. Prior to the Internal Revenue Code of 1954, a post-closing restitution after the year-end was ineffectual, said the Supreme Court.[41] In *Healy* v. *Commissioner,*[42] a cash-basis individual was both an officer and stockholder in his closely held corporation. As a result of his salary being unreasonable, a deficiency was assessed against the corporation and transferee liability against the officer-stockholder. The Court concluded that these later events did not reduce the individual's income for the year he received the salary.[43]

Conversely, entries made on the corporate books prior to the close of the taxable year to adjust for excessive rent expenses have been held sufficient to avert a tax on the landlord-stockholder's actual receipt of the disallowed amount.[44]

Similarly, when a revenue agent's disallowance of an officer's salary for an earlier year prompted him, before the end of 1942, to adjust the latter year's salary by giving the corporation his demand note, before the end of 1942, for the excessive portion of his 1942 salary, the Tax Court ruled that the amount agreed to be refunded was not taxable.[45] To sustain this conclusion, the Court invoked the *Wilcox* theory, pointing out that even if the note could not be regarded as actual repayment, there was a definite obligation at the close of the taxable year to return the disallowed amount. This, of course, suggests that agreements made before the year-end can have retroactive effect, while those after the close of the year are futile for tax purposes.[46]

Post-1953 rule. The new Code does not alter the old rule permitting adjustment of the earlier year's income in a case where repayment or its equivalent was effected *before* the end of that year. Section 1341 of the 1954 Code, however, opens a wide avenue of relief when repayment or similar adjustment occurs *after* the year-end.

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[39] *Appel* v. *United States* (D.C. Mo. 1951), 100 F. Supp. 140, 1941 AFTR 64.

[40] 1954 IRC § 1341, discussed below.

[41] ". . . a potential or dormant restriction, such as here involved, which depends upon the future application of rules of law to present facts, is not a 'restriction on use' within the meaning of *North American Oil* v. *Burnet* . . ."

[42] 345 U.S. 278, 43 AFTR 382 (1953).

[43] An agreement made after the close of the taxable year to refund disallowed rent has been held by the Tax Court to be too late to reduce the stockholder's taxable income for that year. *Ruben Simon,* 11 T.C. 227 (1948).

[44] *Curran Realty Co., Inc.,* 15 T.C. 341 (1950) (A) 1951-1 C.B. 2.

[45] *Willis W. Clark,* 11 T.C. 672 (1948) (NA, C.B. 1949-1, 5). This issue is distinguishable from the treatment of salaries or commissions received in advance but not under a claim of right. *See Wells* v. *United States,* above, footnote 10.

[46] The language of the Supreme Court in the Healy case, above, appears to confine its holding to post-closing repayments, and does not furnish a basis for prediction in preclosing situations.

The new provision provides in general that, where the amount restored exceeds $3,000, the taxpayer shall have, in lieu of a deduction in the later year, an option to reduce his tax in the later year by an amount equal to the tax saving that would have been realized had the income been excluded in the prior year.

This new section will effectively solve the tax dilemma of individuals such as those involved in the *Lewis* and *Healy* cases, discussed above.[47]

In addition, the plight of transferees will in many instances be greatly alleviated. In *Arrowsmith* v. *Commissioner*,[48] the Supreme Court decided that if a stockholder realized capital gain on a corporate liquidating distribution in one taxable year and was subject to liability as a transferee, in a later year, then the deduction in the later year must be treated as a capital loss. The mainfest injustice of a useless capital loss is now eliminated by the right, in effect, to reduce the prior capital gain.[49]

Section 1341 does not apply, in general, to bad debts (because the taxpayer does not lose his unrestricted right to the money) or to sales of inventory or stock in trade (by statutory exception).[50]

To top off this legislative effort to correct an unfair situation is the assurance that the decrease in tax for the prior year will be refunded or credited as an overpayment in the event it exceeds the current year's tax.[51]

Repayment of dividends. In a recent case,[52] a personal holding company distributed a dividend under the mistaken impression that this was necessary to avoid the personal holding company surtax. Before the end of the year, the directors adopted a resolution purporting to rescind the declaration and payment of the dividend, and the taxpayer-stockholders, also before the year-end, repaid to the corporation amounts equal to the dividends received. The Court held that this situation was distinguishable from cases where repaid salaries and rents had not been taxed. In the latter cases, in the words of the Tax Court, there were "repayments made under new contracts entered into by the taxpayers." In the dividend case before it, "repayment was made by petitioners pursuant to unilateral action of the corporation and not pursuant to any new agreement between them and the corporation." The court did not explain how the dividends could have been repaid without agreement by the stockholders.

6. When the Tax Applies to Unclaimed Amounts Due Customers

Unclaimed deposits or other items due to customers will eventually become income by the passage of time although theoretically they may remain liabilities.[53] While they were not originally received under a claim of right they will usually be translated into income at such time as the taxpayer, pursuant to some reasonable policy, elects to write off the liabilities. This procedure, of course, allows the taxpayer some leeway since the choice of years for write-off purposes is largely within his control. It can also, however, be a trap for the unwary taxpayer who unwittingly writes off in one fell swoop a large amount of this type of liability which has been accumulating over a period of years.

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[47] *Senate Finance Committee Report*, 83d Congress, 2d Session, No. 1622 (1954), 118, 451.

[48] 344 U.S. 6, 42 AFTR 649 (1952).

[49] *See Senate Finance Committee Report, op. cit.*, footnote 47, above.

[50] *Ibid.*

[51] 1954 IRC § 1341(b)(1).

[52] *Estate of Lloyd E. Crellin*, 17 T.C. 781 (1951), affirmed (9 Cir. 1953) 203 (F. 2d) 812, 43 AFTR 850, cert. den. 346 U.S. 873.

[53] *Boston Consolidated Gas Co.* v. *Commissioner* (1 Cir. 1942), 128 F. 2d 473, 29 AFTR 531.

This rule has been applied in the case of public utility companies whose books reflected deposits or refunds due customers.[54] A stock brokerage firm which received dividends on securities owned by its customers but recorded in the firm's name was held to have received income after six years even though there was no transfer to surplus.[55] The Board of Tax Appeals agreed with the Commissioner that these unclaimed dividends "should be taken up in income sometime" and that a six-year period was not unreasonable.

On the other hand, customers' deposits received by a mail-order dentist for artificial dentures were held income when received even though there was an agreement for refund in the event of dissatisfaction after a 60-day trial.[56] The deposit was received under a claim of right subject to a condition subsequent, it was held.

7. How to Avoid Some Pitfalls in Taxation of Containers Used in the Sale of Merchandise

Where a charge is made for containers or similar items pending their return following the sale of merchandise, questions arise as to when these charges are reportable as income.

The rule developed by the courts is relatively clear. If the container is actually sold and title passes to the customer, the price at which the container is billed is deemed to be income.[57] Thus, where there was a separate charge for reels which accompanied wires and cables and the taxpayer was referred to as "seller" in a price list of reels, the amounts received were income.[58] The fact that there was an understanding that the reels were returnable within a year for full credit did not alter the complexion of this transaction.

In the absence of a sale of the container, however, the "deposits" received are not income. A Coca-Cola bottling company was held to have realized income, not at the time the deposits were received, but at some later date when unclaimed deposits were closed out.[59] The distinctive markings on the bottles and cases were cited in support of the contention that there was no sale but merely a transfer of possession. If the corporation has credited to surplus in one year a substantial amount of these deposits which have been accumulating over a period of prior years, a tax strikes in that year at the entire amount. This, says the Court, is not mere bookkeeping but a "financial act" creating income. In a more recent case, the Commissioner successfully asserted a tax only upon the excess of deposits received over refunds made during the taxable years involved.[60] The Tax Court intimated that the taxpayer's own estimate of the amount to be taken into income would have been respected had *any* reasonable amount been so reflected. The company's failure to treat any of this excess as income paved the way for the Commissioner's more arbitrary approach.

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[54] *Boston Consolidated Gas Co.* v. *Commissioner,* above, footnote 53.

[55] *Philip Lehman,* ¶ 42,540, Prentice-Hall Memorandum Dec. B.T.A. (1942), CCH B.T.A. Reporter Dec. No. 12,846-A (1942).

[56] *S. B. Heininger,* 47 B.T.A. 95 (1942), rev'd on other issue 133 F. 2d 567, 30 AFTR 936, aff'd 320 U.S. 467, 31 AFTR 783.

[57] *See also* Reg. 118 § 39.22(c)-1, relating to "Need of Inventories" which provides in part as follows:

> "The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer."

[58] *Okonite Co.,* 4 T.C. 618 (1945), aff'd on other issues 155 F. 2d 248, 34 AFTR 1329 (3 Cir. 1946) cert. den. 329 U.S. 764.

Another bottling company was upheld in charging purchases to expense and crediting deposits to income.[61] The Commissioner was rebuffed by the Tax Court in his attempt to require the bottler to inventory bottles for the purpose of computing this income. The inventory method, the court held, was under the Commissioner's own regulations,[62] to be employed only "if title . . . will pass to the purchaser."

Where the directors of a corporation authorized a large amount to be transferred from a deposit liability account to miscellaneous income because its growth was "adversely affecting its financial statements," this was declared to be taxable income.[63]

Simply stated, the crucial factor in container transactions is the passage of title. If it passes, the realization of income is immediate and unalterable. If it doesn't, the dealer will enjoy a reasonable degree of latitude in the exercise of his discretion.

8. How to Handle Prepaid Income

An illustration will explain this. On October 1, 1955, a television repair service company enters into a three-year service contract to expire September 30, 1958 at a charge of $300. In violation of generally accepted accounting principles, the Internal Revenue Service has, in many instances, required the $300 to be treated as 1955 income.

This approach has been sanctioned by the courts in a number of cases.[64] Admittedly, this judicial construction of Section 41 of the Internal Revenue Code of 1939 has furnished a certain amount of support for this concept. Thus, advance rentals have been held income in the year received;[65] contracts for membership in a gymnasium or health club were similarly treated.[66] The sale of coupon books for automobile service and lubrication has been labeled income in the year of the sale although coupons are redeemable upon request or services will be rendered in a subsequent year.[67] Tickets sold by an airline but not used by the purchaser in the year of sale have been placed in the same category.[68]

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[59] *Wichita Coca-Cola Bottling Co.* v. *United States* (5 Cir. 1945), 152 F. 2d 6, 34 AFTR 531, cert. den. 327 U.S. 806. The taxpayer here had previously agreed to deficiencies for the years 1937 to 1939 inclusive based upon taxing the *increases* in the deposit account. During the taxable year before the court, 1940, taxpayer had closed out to surplus the remaining balance in the account, representing pre-1937 deposits. Taxation of this entire amount in 1940 appears to be inequitable under the circumstances. This case was followed in *Farmers Creamery Co.*, 14 T.C. 879 (1950).

[60] *Fort Pitt Brewing Co.*, 20 T.C. 1 (1953), affirmed (3 Cir. 1954) 210 F. 2d 6, cert. den. June 1, 1954.

[61] *Hugh Smith Estate*, 6 T.C.M. 358 (1947).

[62] Reg. 103 § 22(c)-1 (as amended by T.D. 4981 7-3-40). Current regulations are to the same effect. *See* footnote 57, above.

[63] *Nehi Beverage Co.*, 16 T.C. 1114 (1951).

[64] Cases involving sales, as distinguished from services, do not appear to be controlled by this rule. A sale is generally reflected for tax purposes in the year in which it becomes a closed transaction. *See Veenstra & DeHaan Coal Co.*, 11 T.C. 964 (1948).

The Tax Court has refused to allow a publishing company on the *cash* basis[69] to defer amounts representing advance subscriptions,[70] citing the *Lewis* case[71] as a reaffirmation of the claim of right theory. This, said the Court, outweighed the taxpayer's claim of a consistent "hybrid" method of accounting employed and known to the Commissioner for over twenty years. A severe jolt to this entire concept was administered by the decision in *Beacon Publishing Company* v. *Commissioner*[72] which held that to treat prepaid subscriptions as income in the year of prepayment instead of deferring it to the year earned, will give rise to "an incongruous result" and "a distortion of an accrual taxpayer's true income."

This principle was also invoked against a warehouse company, which had set aside out of current income a "Reserve for Handling Out," an expense which would surely be incurred in later years.[73]

Section 452 of the 1954 Code[74] allowed the taxpayer to elect to defer prepaid income under certain conditions. This provision of the 1954 Code would have eliminated much of the hardship inherent under the old rules discussed in this section. However, Section 452 was repealed [75] retroactively to its original effective date. The Senate Finance Committee Report[76] makes abundantly clear that this repealer was adopted "reluctantly" and only out of deference to the Secretary of the Treasury, who requested it. The Committee stated that it expected to report out new legislation on this subject at an early date with the avowed purpose of restoring order to the "state of confusion and uncertainty" which prevails. This admission serves only to strengthen the voices[77] heard in many quarters that say that existing laws have never sanctioned the taxing of prepaid income prior to the year in which it is earned.

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[65] *South Dade Farms, Inc.* v. *Commissioner* (5 Cir. 1943), 138 F. 2d 818, 31 AFTR 842; *Palm Beach Aero Corp.*, 17 T.C. 1169 (1952). In *Hyde Park Realty, Inc.* 20 T.C. 43 (1953), affirmed (2 Cir. 1954) 211 F. 2d 462, 45 AFTR 812, the court held the purchaser of rental property taxable on the amount allowed by the seller representing rentals collected prior to closing of title relating to a period after the closing. The tax does not apply, however, to security deposits which constitute trust funds and are not held under a claim of right. *See Estate of George E. Barker*, 13 B.T.A. 562 (1928) (A, C.B. Dec. 1931, 5).

[66] *Your Health Club, Inc.*, 4 T.C. 385 (1944) (A, C.B. 1945, 7).

[67] *South Tacoma Motor Co.*, 3 T.C. 411 (1944).

[68] *National Airlines, Inc.*, 9 T.C. 159 (1947).

[69] *See* I.T. 3369 (C.B. 1940-1, 46) which grants permission to defer subscription income and expenses in the case of *accrual* basis taxpayers.

[70] *Booth Newspapers, Inc.* v. *Commissioner* (6 Cir. 1952), 201 F. 2d 55, 43 AFTR 118.

[71] 340 U.S. 590, 40 AFTR 258 (1951), discussed at length, above.

[72] (10 Cir. 1955) 218 F. 2d 697.

[73] *Capital Warehouse Co., Inc.* v. *Commissioner* (8 Cir. 1948), 171 F. 2d 395, 37 AFTR 644. *See also Brown* v. *Helvering*, 291 U.S. 193, 13 AFTR 851 (1934) in which the Supreme Court did not permit overriding commissions received by the general agent for a fire insurance company to be reduced by estimated future cancellations or to be allocated to future years by reason of services to be rendered in the future. But *see* 1954 IRC § 462 providing election for reserves for estimated expenses, etc., retroactively repealed.[74]

[74] H.R. 4725, Public Law 74, 84th Cong., 1st Sess., approved June 15, 1955.

[75] See footnote 73, above.

[76] Senate Finance Committee Report, 84th Congress, 1st Session, No. 372 (1955) 1-11.

9. How Dealers Can Postpone Taxation of Reserves for Financed Sales

In certain industries where financing of sales is customary, the finance company, in addition to deducting its regular charge for discounting notes, may withhold a reserve based upon uncollected amounts outstanding.

The decisions vary with the facts. Where losses on bad accounts may be charged against the reserve, the reserved amounts are not income to the dealer until actually paid over by the finance company.[78] In other situations, where the reserve is not technically chargeable with losses but results merely in "delaying" payment to the dealer (because the required ratio of reserve to unpaid notes is not attained), the dealer is not permitted to exclude the reserved amount from his income.[79]

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[77] Stanley P. Wagman, "Sections 452 and 462: Stormy Past but a Bright Tomorrow," *Taxes*, October 1955, Vol. 33, page 711; Sidney Gelfand, "The 'Claim of Right' Doctrine," *ibid*, page 726.

[78] *Keasbey & Mattison Co.* v. *United States* (3 Cir. 1943), 141 F. 2d 163, 32 AFTR 261.

[79] *Shoemaker-Nash Co.*, 41 B.T.A. 417 (1940); *Town Motors, Inc.*, 5 T.C.M. 625 (1946).

15

How to Select or Change the Accounting Period

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Fundamental to our system of a federal income tax is the requirement that net income shall be reported and the tax paid on an annual basis. But within certain limits the taxpayer may select the annual accounting period he prefers or the occasion for a change to a different period. Consideration of the rules governing the subject, as set out in this chapter, will permit selection of the best available alternative.

1. Points to Consider

If you are confronted with the problem of selecting an accounting period you will have to consider:

	Section
What periods are available	2
Whether the "natural" year for your business is desirable for tax purposes	3
Whether the trend in tax rates should influence your decision	3
When your selection should be made	4

If you are considering a change in your accounting period you will want to know:

	Section
If and when you must secure the Commissioner's approval	5
What are the tax consequences of the change?	6
Alternative methods of computing the tax and how the most advantageous method may be availed of	6
When the change may be made most advantageously	7

Finally, if you are selecting or changing the accounting period of a partnership, of an individual who is a member of a partnership, or of an estate, trust, or beneficiary, you will want to consider the special problems discussed in Sections 8 and 9.

2. What Accounting Periods Are Available?

If you are about to file your first return, certain alternatives may or may not be available.[1] If you do not "keep books" you have no alternative and *must* use a calendar year for filing your returns.[2] If, on the other hand, you do keep books,[3] the accounting period to be used in your returns will be governed by the period regularly employed in keeping your books.[4] You do not need the permission of the Commissioner initially to establish this period.[5] But your choice is limited to a calendar year or a "fiscal" year.[6] A calendar year is defined as a period of twelve months ending on December 31; a fiscal year is a twelve-month period ending on the last day of any month other than December.

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[1] 1954 IRC § 441; 1939 IRC § 41.

The definition of fiscal year also includes the so-called 52-53 week year.[7] This is an annual period which varies from 52 to 53 weeks and ends always on the same day of the week.[8] Under the statute, the ending of the 52-53 week year may be determined in one of two ways; it may end on the selected day (1) which *last occurs* in the selected calendar month; or (2) which is *nearest to* the last day of the selected calendar month.[9] Any taxpayer, including individuals and partnerships, as well as corporations,[10] may elect to use a 52-53 week year for taxable years ending after enactment of the 1954 Code.[11] If you use the 52-53 week year, and the effective date or applicability of a provisions of the Code is expressed in terms of a taxable year beginning or ending on the first or last day of a calendar month, your taxable year is considered for this purpose to begin or end on the first or last day of the month which is nearest to the beginning or ending of your taxable year.[12]

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[2] 1954 IRC § 441(g); 1939 IRC § 41.

Under the 1939 Code and similar provisions of earlier revenue acts, it was held that deposit slips, check stubs, receipts, statements, and other informal memorandum records do not constitute "books" within the meaning of the statute. *Max H. Stryker*, 36 B.T.A. 326 (1937); *Louis M. Brooks*, 6 T.C. 504 (1946). In the *Senate Finance Committee Report* No. 1622, 83rd Congress, 2d Session, to accompany H.R. 8300, the Internal Revenue Code of 1954, page 299, it was stated:

> "The use of books in subsection (g) is not intended to connote a requirement that records be bound. Any records sufficient to clearly reflect income will meet the requirements of this section."

There was no similar statement in the report of the House Ways and Means Committee. It is not clear whether the statement was intended to overrule the decisions cited above. In any event, you would be well advised not to rely on such "legislation by committee report." In order to be sure that you meet the requirement of the statute, you should keep at least a book of original entry and a ledger showing assets and liabilities as well as income and expense accounts.

[3] In the case of a foreign corporation having "books" at the home office and also in the United States, it has been held that the accounting period used in the United States books covering United States income is controlling. *Linen Thread Co., Ltd.*, 14 T.C. 725 (1950).

[4] If you close your books on the basis of one accounting period but file your returns for a different period, the Commissioner may adjust your returns to conform to your books. *Jonas Cadillac Co.*, 16 B.T.A. 932 (1929), affirmed (7 Cir. 1930) 41 F. 2d 141, 15 AFTR 590; *Great West Printing Co.*, 22 B.T.A. 346 (1931), affirmed (8 Cir. 1932) 60 F. 2d 749, 11 AFTR 824. If, pursuant to the rules of some State or Federal regulatory body, such as the Interstate Commerce Commission, you keep your books on a calendar year basis, the Commissioner cannot determine deficiencies on the basis of a fiscal year, even though your original returns were filed on such basis in accordance with carefully prepared and accurate audit reports. *Atlas Oil & Refining Corporation*, 17 T.C. 733 (1951), acquiesced 1952-1 C.B. 1.

[5] *Senate Finance Committee Report, op. cit.* footnote 2 above, page 299; *House Ways and Means Committee Report* No. 1337, 83rd Congress, 2d Session, to accompany H.R. 8300, the Internal Revenue Code of 1954, p. A-157; O.D. 404, 2 C.B. 67 (1920).

[6] 1954 IRC § 441(d) and (e); 1939 IRC § 48(a) and (b). But see Section 8 of this chapter for further restrictions on selection of the accounting period in the case of a partnership or an individual who is a member of a partnership.

[7] 1954 IRC § 441(f).

[8] The 52-53 week year is frequently used by businesses (such as retail sales, motion picture theaters, and the radio and television industry) in which weekly comparisons are important.

[9] The "last occurs" method will produce a period which always ends in the same calendar month and which deviates from a "true" fiscal or calendar year by as much as six days. On the other hand, the "nearest to" method will result in a period which may end, from time to time, in either one of two calendar months but will not deviate from a "true" calendar or fiscal year by more than three days. Business conditions or methods of operation will govern the choice between the two methods.

If, for your own accounting purposes, you use any period other than a calendar, fiscal, or 52-53 week year, or if you do not use any regular annual accounting period, the statute requires that your net income be computed on the basis of a calendar year.[13]

When the taxpayer is in existence during only part of what would otherwise be his taxable year (i.e., in the case of his first or last return) he is required to make a return for this fractional part of a year, comprising a period of less than 12 months.[14] In such case, the income for the short period is not to be "annualized," [15] and, in the case of an individual, estate, or trust, the exemption deduction is not to be prorated.[16]

A short period may also result when the Commissioner terminates the taxable year because the tax is in jeopardy.[17] In such case, the income is not to be annualized and the exemption is not prorated.[18]

3. What You Should Consider in Making the Selection

If your business is such that the flow of income and expenses is more or less uniform throughout the year you could probably select any of the accounting periods sanctioned by the statute. But if your business is a seasonal one in which the peak of activity is concentrated in particular months, you will want to select the "natural" year for such business. You will want to end your year soon after the peak months when inventories and accounts receivable are at a minimum.[19] If the peak of income and the peak of expenses occur at different periods of the year, you will not want to distort the income for the "natural" business year by placing such peaks in different taxable years.

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[10] A partnership may use a 52-53 week year. The term "taxpayer" used in § 441(e) and (f) does not include a partnership (see definitions at § 7701(a)(1) and (14)), but § 706(b)(1) provides that the taxable year of a partnership shall be determined "as though" the partnership were a taxpayer.

[11] Statutory recognition of the 52-53 week year was new in the 1954 Code. Previously, the courts had refused to accept it as a fiscal year. *Swift & Co.* v. *U.S.*, 38 F. 2d 365 (Court of Claims 1930), 8 AFTR 10182. But where the taxpayer had used such an accounting period over a long period of time, the Internal Revenue Service, as a matter of administrative policy, had accepted returns filed on this basis. *See* statement of the Commissioner, 1954 *Prentice-Hall Federal Tax Service,* Vol. 1, para. 6131-C.

[12] 1954 IRC § 441(f)(2)(A).

[13] 1954 IRC § 441(g); 1939 IRC § 41, Rev. Rul. 54-273, 1954-2 C.B. 110.

[14] 1954 IRC § 443(a)(2); 1939 IRC § 47(b) and (g); Reg. 118, § 39.47-1(b). Such short period is technically a "taxable year." 1954 IRC § 441(b)(3), 1939 IRC § 48(a). No return can be made for a period of more than 12 months. Reg. 118, § 39.47-1(a).

[15] 1954 IRC § 443(b)(1); 1939 IRC § 47(c)(1).

[16] 1954 IRC § 443(c); 1939 IRC § 47(e); Reg. 118, § 39.47-1(a).

[17] 1954 IRC § 443(a)(3), § 6851; 1939 IRC § 47(f), § 146.

[18] *See* footnote 14, above. Under the 1939 IRC § 47(e) in jeopardy cases the exemption was prorated. In some cases the terminated period may be the basis for a final return, as for example, when a resident alien ends his residence in the United States and thereafter has no further income from sources within the United States. In other instances, the taxpayer may be liable for a full taxable year return even though his taxable year has been "terminated" one or more times. In such case, he is to file the full year's return including the income and deductions included in the "terminated" period or periods, and is to take credit on the final return for the tax paid on such "terminated" returns. 1954 IRC § 6851(b); G.C.M. 17195, XV-2 C.B. 107 (1936).

If you are engaged in two or more lines of business, you cannot use different accounting periods for each.[20] It would be advisable to select the period best suited to the predominant business.

If the requirements for a "natural" seasonal year are not too urgent, you will want to consider when your personnel has the time available for closing the books and preparing the returns. Your accountant will probably be very busy at March and April 15th preparing calendar year returns. Or you may have other statements or reports which must be prepared on a calendar year basis. In such case you would probably be better off if you selected a fiscal year.

If you have a new corporation that is, or may become, either a parent or subsidiary of an affiliated group, you may want to make the accounting period conform to that of the other members of the group. Then if you decide to file consolidated returns you will not have to make the change[21] at a time when it may be inconvenient or costly.

You may also want to consider whether the trend of tax rates is upward or downward. Prior to 1942, Congress followed the practice of having new revenue acts providing for a change in rate of tax effective for taxable years beginning on and after January 1. Accordingly, fiscal year taxpayers had the advantage of having the part of their year which overlapped the succeeding calendar year taxed at the lower rate. To eliminate this advantage, the Revenue Act of 1942,[22] all succeeding acts,[23] and the 1954 Code[24] which made changes in rates provided for proration of the old and new rates to the portions of the fiscal year before and after the effective date of the new rate. So long as this policy is followed there is no rate advantage or disadvantage in being on a fiscal year.[25]

4. When Your Selection Should Be Made

There are two reasons why you should make the selection of your accounting period as soon as possible:

1. A fiscal year must be definitely established before its close and the books must be kept accordingly.[26] Thus, if you want to use a fiscal year ending on the last day

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[19] It is for this reason that most department stores select a fiscal year ending January 31.

[20] O.D. 941, 4 C.B. 71 (1921); Bureau letter dated Nov. 27, 1945, 1946 *Prentice-Hall Federal Tax Service*, Vol. 5, par. 76,041. Of course, if one of the lines of business is separately incorporated, or is carried on by a partnership, a separate accounting period may be established.

[21] Reg. 129, § 24.14. The accounting period of the parent determines the period for the affiliated group. *Wells-Gardner & Co.*, 34 B.T.A. 1075 (1936), affirmed (D.C. Cir. 1938) 95 F. 2d 125, 20 AFTR 1075.

[22] 1939 IRC § 108(a) as added by the Revenue Act of 1942; *House of Representatives Report* No. 2333, 77th Congress, 1st Session: *Senate Report* No. 1631, 77th Congress, 2d Session; 1942-1 C.B. 372, 400, 441, 533, 587, also conference statement at page 707.

[23] 1939 IRC § 108(b), (c), (d), (e), (f), (g) and (h) as added by the Revenue Acts of 1943, 1945, 1948, 1950 and 1951.

[24] 1954 IRC § 21.

[25] In the case of partnerships, *see* § 8 of this chapter.

[26] Reg. 118, § 39.41-4.

of a month soon after the taxpayer has come into existence, you will have to make up your mind promptly so that you can close the books on that date.

2. The year starts to run when the taxpayer comes into existence,[27] and a period during which the taxpayer was in existence but doing no business must be included in the first accounting period. This period, when added to the period of actual business activity ending on the last day of the selected accounting period, may total more than 12 months. Since a return cannot be filed for a period of more than 12 months,[28] you may find that you have missed the opportunity to establish the accounting period you prefer.[29]

5. When and How the Accounting Period May Be Changed

If you have an established accounting period, but wish to change to a different one, you must file a return for the short period from the end of your old period to the beginning of the new one. For example, if you were previously on a calendar year basis and wish to change to a fiscal year ending October 31st, you will have to file a return for the short period from January 1st to October 31st. In certain situations, you must first secure the approval of the Commissioner of Internal Revenue in order to make the change.[30] If you have previously changed your accounting period at any time within the five calendar years ending with the calendar year which includes the begining of the short period required to effectuate the change, you must secure the Commissioner's approval to make another change.[31] If the new accounting period deviates from the old by more than three months, approval is required. If the net income when annualized for the short period is less than 30 per cent of the net income for the preceding full taxable year, the Commissioner's approval must be obtained. Approval must also be obtained if you have previously filed on a calendar basis because you kept no books or had not established a regular or statutory accounting period, and thereafter, having started to keep books or having established a proper accounting period, you wish to go on a fiscal year basis.[32]

Application for approval of a change in accounting period, where necessary in the situations discussed above, is made directly to the Commissioner of Internal Revenue at Washington, D.C., on Form 1128. It must be filed on or before the 15th day following the close of the short taxable year required to effectuate the change.[33]

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[27] Reg. 118, § 39.52-1(b). *Ajax Engineering Corporation*, 17 T.C. 87 (1951), affirmed per curiam (3rd Cir. 1952), 196 F. 2d 727, 41 AFTR 1235. Cf. *Eveready Loan Co.*, 2 T.C. 1035 (1943).

[28] *See* footnote 14, above.

[29] I.T. 3466, 1941-1 C.B. 238. *See also Atlas Oil & Refining Corporation, op. cit.*, footnote 4 above.

[30] 1954 IRC § 442; 1939 IRC § 46; Reg. 118, § 39.46-1 and 2. For short taxable years ending prior to July 1, 1953, the Commissioner's approval was required in all cases. T.D. 6035, 1953-2 C.B. 147.

[31] For this purpose a change by a partnership or trust is deemed to be a change by a partner or beneficiary and vice versa.

[32] An explicit provision to this effect is new in the second sentence of § 442 of the 1954 Code. The language used is somewhat obscure and must be read in conjunction with § 441(g) and (c). Under § 441(c) the "annual accounting period" is the period regularly used in keeping the taxpayer's books. If he keeps no books or has no regular statutory period, § 441(g) does not give him an "annual accounting period," but merely requires that his *taxable year* must be a calendar year. Thus, if he adopts a fiscal year (which he can do only by keeping books, or establishing a proper accounting period on his books), then, as a matter of technical definition, he has established rather than changed his "annual accounting period." Nevertheless, this is treated as a change requiring the Commissioner's approval. The provision should not be interpreted as giving the Commissioner the right to approve a fiscal year for a taxpayer with no books or no proper accounting period on his books.

In cases other than the four situations discussed above, an application for approval is not required, but a statement should be made to accompany the short period return, stating that the change has been made in accordance with authorization granted in the regulations.[34]

It would be unwise to make any change in your accounting period without first securing the Commissioner's permission in any case in which approval is required. In such case, the change may be accepted by the Commissioner if he acts upon returns filed for the new period. But he may refuse to accept, and may restore you to your old period.[35] The Commissioner will generally grant your application if there is a sound business reason for the change. But he will refuse permision if the patent purpose is to shift income or deductions from one period to another in order to minimize tax liability, or if the change will produce a distortion of net income. If permission is granted the Commissioner will specify the conditions which must be met, which include closing the books and filing returns in accordance with the new period.

If you are married and wish to file a joint return with your spouse, you may do so only if you have both established the same accounting period.[36] The fact that a taxpayer marries does not automatically change her accounting period to that of her husband and she does not become a "new taxpaying personality." [37] In order to conform her accounting period to that of her husband, she must file a timely application and secure the Commissioner's approval, if, under the regulations, such approval is required.

6. What Are the Tax Consequences of the Change?

When you file a return for a short period in order to effect a change in your accounting period, you must first annualize the net income,[38] compute the tentative tax on an annual basis, and then reduce it by multiplying it by the fraction of the year covered by the return.[39] You may be penalized by this procedure if the income during the short period has been higher than average, and you are subject to graduated tax rates. To alleviate this hardship, you can use an actual twelve-month period for the computation instead of annualizing the income for the short period.[40] The period used is the twelve months beginning with the first day of the short period.[41] In effect, enough months are added to the short period to equal twelve. A tentative tax is computed on the net income for the twelve-month period and tax is allocated to the short period in proportion to the income attributable to the short period.[42] There is a limitation upon this computation. The tax liability may not be less than would result if the tax were computed on the net income for the short period without placing it on an annual basis. In effect, this means that any net loss sustained during the months which have been added to fill out the twelve-month period may not be used for the purpose of reducing the net income for the short period.[43]

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[33] For short taxable years ending prior to July 1, 1953, the application had to be filed at least 60 days before the close of the short period. The Commissioner may reject an untimely application. *East Coast Motors, Inc.*, 35 B.T.A. 212 (1936).

[34] Reg. 118 § 39.46-1(b)(1). If the change is to conform a subsidiary's period to that of the parent in an affiliated group, Form 1128 must be completed and filed with the district director of internal revenue at or before the time of filing the consolidated return. Reg. 118, § 39.46-1(b)(5).

[35] *Jonas Cadillac Co., op. cit.*, footnote 4, above; *Clark Brown Grain Co.*, 18 B.T.A. 937 (1930); *Andrew John Williamson*, 22 T.C. No. 88 (1954).

[36] 1954 IRC § 6013(a)(2); 1939 NRC § 51(b)(3). There is an exception to this rule in the case of the death of a spouse or both of them.

[37] *Irene Nunnery Theriot*, 15 T.C. 912 (1950), affirmed (5 Cir. 1952) 197 F. 2d 13, 41 AFTR 1369, cert. den. 344 U.S. 874 (1952).

[38] Under the 1954 Code the exemption allowed an individual, estate or trust is technically a deduction. Accordingly, § 443(c) provides that you must prorate the exemption to the short period covered by the return in order to obtain the net income subject to annualization. Under the 1939 Code the exemption was a "credit" and was deducted from the annualized net income. Similarly, under the 1939 Code, the corporate credit for dividends received (§ 26(b)) and the credits for interest on certain U.S. obligations (§ 25(a), § 26(a)) also had to be annualized. Since, under the 1954 Code, these items are deductions (§ 243) or credits against the tax (§ 35), the adjustment is no longer necessary.

The return for the short period must be filed on or before the fifteenth day of the fourth month following the close of the short taxable year.[44] This is the same rule as is applicable to a full taxable year. If the relief provisions will reduce the tax for the short period, you must file the return without regard to such provisions and then obtain your relief by filing a claim for refund.[45] Under ordinary circumstances, the claim must be filed not later than the filing date for your next return.[46]

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[39] 1954 IRC § 443(b)(1); 1939 IRC § 47(c)(1). The statutory formula is:

$$\frac{\text{(Net income for short period} \times 12)}{\text{(number of months in short period)}} \begin{matrix}\text{at applicable rates}\\ \text{and brackets}\end{matrix} \times \frac{\text{number of months in short period}}{12}$$

Obviously, if the taxpayer is subject to a flat rate, the formula resolves to net income times flat rate. If an effective date of a change in tax rates falls within the short taxable year, so that 1954 IRC § 21 or 1939 IRC § 108 is applicable, the tentative taxes are computed on the annualized income and the proration formula for the change in rates is applied. The resulting tax on the annualized income is then reduced as in the last step of the formula shown above.

[40] 1954 IRC § 443(b)(2); 1939 IRC § 47(c)(2).

[41] If the taxpayer was not in existence for this entire twelve-month period or, in the case of a corporation, had disposed of substantially all its assets in such time, the period to be used is the twelve months ending with the last day of the short period. In other words, the "added" months are those preceding rather than those following the short period. In such case the reduction in tax is to be claimed in the return rather than by way of a claim for refund. *See* Reg. 118, § 39.47-2(b)(1); § 39.47-2(c).

[42] The statutory formula is:

$$\text{Tax on twelve months income} \times \frac{\text{Net income for short period}}{\text{Net income for 12-month period}}$$

If a change of rate falls within the extended twelve month period, the tax for such period must be computed under 1954 IRC § 21 or 1939 IRC § 108.

[43] The limitation is for the purpose of preventing any loss during the "added" months from being utilized twice: first, in computing the tax for the short period and again in computing the tax (or net operating loss) for the taxable year of which the "added" months form a part.

[44] 1954 IRC § 6071; Reg. 118, § 39.46-1(b)(1). The date is the fifteenth day of the third month in the case of corporations.

[45] The relief may be denied if the claim is not filed. *Andrew John Williamson, op. cit.*, footnote 35, above.

[46] 1954 IRC § 443(b)(2)(C); 1939 IRC § 47(c)(2). The language of the statute is formidable. It states that the claim must be filed not later than "the time (including extensions) for filing the return for the first taxable year which ends on or after the day which is 12 months after the first day of the short period." The intent of the statute apparently is to have the claim filed at the same time as the return which covers the "added" months, so that the method of

If you apply for relief under this provision, you may be confronted with several problems. First, the statute prescribes that the tax for the twelve-month period is to be computed as if the twelve-month period were a taxable year, and under the law applicable to such year. This means that you will have to watch out for changes in the law. Suppose, for example, you were changing from a fiscal year ended July 31st to a calendar year and your short period return was from August 1st to December 31st. Your added months would be from January 1st to July 31st of the following year, making a twelve-month period ending July 31st of the following year. If there were changes made in the statute applicable to taxable years beginning on and after January 1st, such changes would not apply to the computation of the tax for the short taxable year based on the income for the twelve months ended July 31st. They would, however, apply in computing the tax for the first calendar year under your new accounting period.

A related problem is the computation of the net income for the extended twelve-month period. This period may end at a time when you have not taken inventory or made all the necessary accruals. You will therefore have to make some reasonable allocation of such overlapping items.[47]

Special rules are provided for the computation of tax for a short period in the case of changes to or from a 52-53 week year.[48] If the change is to a 52-53 week year ending on the day of the week which last occurs in, or is nearest to the last day of, the same calendar month which you formerly used for your old calendar or fiscal year, you will have a short period which consists of less than seven days or which consists of 359 or more days. For example, if you were formerly on a calendar year and in 1955 changed to a 52-53 week year ending on the Sunday nearest to the last day of December, your short period would consist of the two days January 1st and 2nd, 1955. Since this is less than seven days, you need not file a return for the short period, but you add the income and deductions for the two days to the return for the period which will end January 1, 1956, and compute the tax on the income for this period in the usual manner without annualization or other adjustment. On the other hand, if in 1954 you change to a 52-53 week year ending on the Sunday last occurring in December, your short period would consist of the 360 days from January 1, 1954 to December 26, 1954, inclusive. Since this is more than 359 days, you would file a return for this period, but without annualizing the income or otherwise adjusting the tax computed in the usual manner.[49]

If your new 52-53 week year ends on a day of the week which last occurs in, or is nearest to the last day of, a calendar month other than the last calendar month of your old calendar or fiscal year, your short period will consist of more than seven days or less than 359 days. For example, if in 1953 you were on a calendar year, and changed in 1954 to a 52-53 week year ending on the Saturday last occurring in

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determining the income for the "added" months can be verified at the same time as the return of which they form a part is verified. The involved language was apparently used to cover the exceedingly remote possibility of two consecutive returns, each for a short period.

[47] The regulations allow you some latitude in making the apportionment. Reg. 118 § 39.47-2(b)(3).

[48] 1954 IRC § 441(f)(2)(B).

[49] It should be noted that, in some instances, you can change to a 52-53 week year without having *any* short period. For example, if in 1954 you changed from a calendar year to a 52-53 week year ending on the Friday last occurring in, or nearest to the last day of, the month of December, you would have no short period, since December 31, 1954, was a Friday.

November, your short period would be from January 1, 1954 to November 27, 1954, or a period of 331 days. In such cases, you must file a return for the short period, annualizing the income and prorating the tax in the usual manner, except that the annualization and proration is based on the number of days rather than the number of months in the short period.[50]

The rules discussed above also apply to a change from a 52-53 week year to a conventional calendar or fiscal year.

7. Watch These Factors in Timing Your Change

Because of the ways in which the tax is computed, you will want to time your change of accounting period so that the net income for the short period is neither too much above nor below your average monthly rate of net income. Essentially, this is a matter of estimating nonrecurring items of income and deduction, and also of any abnormal rise or fall in the normal flow of net income. Included in these considerations is the question of whether you have had, or expect in the future to have, a net operating loss which you can utilize as a carry-over or carry-back deduction. These losses are spread over a cycle of eight taxable years: the year in which the loss arose, the two preceding years, and the five succeeding years.[51] The short period resulting from a change in accounting period is a taxable year even though it may cover as little as seven days.[52] Thus, if a net operating loss arises in either the five years preceding the short period, or the two succeeding years, the short period will count as a taxable year. That may substantially limit the number of days during which the loss may be offset against otherwise taxable income.

8. Special Problems Involving Partnership Returns

If you are a member of a partnership, you will have certain special problems to consider in selecting or changing the partnership's accounting period. A partnership is not a taxable entity, and the individual partners report and pay tax on their share of the net income for the taxable year of the partnership which ends with or within the partner's taxable year.[53] Under the 1939 Code, you could, by selecting a partnership accounting period ending in the partner's next taxable year, defer paying tax on the partnership income for a full year. Under the 1954 Code, there is a specific limitation upon the adoption or change of a partnership accounting period, or a change in a partner's accounting period.[54] A partnership may not change to, or adopt, a taxable year other than that of all its principal partners unless it establishes, to the satisfaction of the Secretary, an adequate business purpose. The term "principal partner" is defined to mean one having an interest of 5 per cent or more in partnership profits or capital. Furthermore, a partner may not change to a taxable year other than that of a partnership in which he is a principal partner unless he establishes a business purpose for the change.

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[50] It should be noted that in the changes described in this paragraph, the relief provisions of § 443(b)(2) are available, but they are not available or necessary in the cases described in the preceding paragraph.

[51] 1954 IRC § 172. Under the 1939 IRC §§ 23(s) and 122, the cycle varied from three to seven years.

[52] 1954 IRC § 441(b)(3); 1939 IRC § 48(a). Note that the period of less than seven days mentioned in § 441(f)(2)(B)(i) and (ii) is not itself a taxable year within the definition of § 441(b) although the year to which it is added is a taxable year. Within the limitation of all other factors, "short periods" should be as "long" as possible in order to fully utilize carry-overs and carry-backs.

[53] 1954 IRC §§ 701 and 706; 1939 IRC §§ 181 and 188.

[54] 1954 IRC § 706(b). Under § 771(b) these rules apply to the adoption of, or change to, a taxable year beginning after April 1, 1954.

Several problems may arise from these restrictions. If the principal members of a new partnership have individually established different taxable years, it is obviously impossible for the partnership to adopt a year conforming to that of *all* its principal partners. Perhaps in such cases the Secretary will require the individual members to conform their individual years to that of the partnership. Similar problems will arise where one individual is a principal partner in more than one partnership.

The new Code also provides a set of rules as to the closing of a partnership taxable year by reason of the death of a partner, a change in partners' interests, or the termination of the partnership.[55]

The entry of a new partner does not close the partnership year. Similarly, the sale, exchange or liquidation of a part of a partner's interest does not close the partnership taxable year. With respect to a partner who sells or exchanges his entire interest or whose entire interest is liquidated other than by reason of his death, the taxable year of the partnership as to his interest is closed as of the date of the sale, exchange or liquidation. In such cases, however, the taxable year will continue to its normal closing date with respect to the remaining partners.[56]

In the event of the death of a partner the taxable year does not close as to the remaining partners.[57] With respect to the deceased partner, the taxable year will ordinarily terminate as to his interest when his entire interest is liquidated or sold. But for the taxable year of the partnership which includes the date of his death, the year will continue to its normal closing date even though his interest is completely liquidated before such date.[58]

A partnership is terminated (and hence its taxable year closed) only if (1) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or (2) within a twelve-month period there is a sale or exchange of 50 per cent or more of the total interest in partnership capital and profits.[59] In the case of merging or consolidating partnerships, any of the old partnerships, whose members own 50 per cent or less interest in the capital and profits of the resulting partnership, is considered terminated and its taxable year closed.[60] Conversely, if an existing partnership is divided into two or more "new" partnerships, the resulting partnerships are considered new partnerships for tax purposes only if their members had an interest of 50 per cent or less in the capital and profits of the prior partnership.[61]

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[55] 1954 IRC §§ 706 and 708.

[56] Of course, if there is only one remaining "partner," the business is no longer "carried on by any of its partners *in a partnership*" and is considered terminated under § 708(b)(1)(A).

[57] Under the 1939 Code, a clear and definite rule had not been provided by the court decisions and administrative rulings. O.D. 228, 1 C.B. 290; revoked, Rev. Rul. 144, 1953-2 C.B. 212; *Mary D. Walsh* 7 T.C. 205 (1946); *Estate of Joseph E. Tyree*, 20 T.C. 675 (1953); *Heiner* v. *Mellon*, 304 U.S. 271 (1938), 20 AFTR 1263.

[58] This exception to the general rule, contained in § 706(c)(2)(A)(ii), would not apply in the event the deceased partner's entire interest is sold, rather than liquidated, before the end of the partnership's taxable year. *See* definition of liquidation at § 761(d). Since the deceased partner's taxable year ends with the date of his death, the effect of this provision is that the income for the partnership year which includes the date of his death will be reported in the return of his estate or beneficiary rather than in his final return, unless he should happen to die on the last day of the partnership's taxable year.

[59] A gift or transfer as bequest, devise or inheritance, will not come within this provision *See House of Representatives Conference Report* No. 2543, 83rd Congress, 2d Session, covering the 1954 Code, page 6J

If you are, or expect to become, a member of a partnership, a knowledge of these rules is imperative. Any of the events mentioned above could terminate the partnership or otherwise close your partnership taxable year. If this occurs, you may find that two partnership taxable years end in your individual taxable year, and hence you may have an amount representing almost two years partnership income "bunched" in one year.[62] You will therefore be careful to see that any voluntary act, such as cessation of business, sale of controlling interest, merger, consolidation or division of a partnership, or liquidation or sale of your entire interest, occurs at a time which will not cause the closing of two partnership periods in your one individual taxable year.[63]

Similar considerations are necessary if you make a change in the partnership or partner's accounting period. In the case of a partnership change, the net income and other items for the resulting short period are not to be annualized,[64] but the partner's share thereof is reported in his return for the taxable year in which the short period ends. Hence, two partnership periods may end in one individual taxable year. If this cannot be avoided, the change should be so timed that the distortion of income will be minimized. In the case of a change of a partner's accounting period, care should be exercised that a partnership period does not end with or within the individual's short period.[65]

9. Problems of Estates and Trusts

What has been stated in the preceding section with respect to the special problems of partnerships is to a limited extent also true with respect to estates and trusts. Unlike partnerships, estates and trusts are taxable entities,[66] but they are allowed certain deductions for amounts which are distributed or distributable to the legatees, heirs, or beneficiaries.[67] These deductions are analogous to the partner's distributive share of the partnership income, and are to be reported by the legatee, heir, or beneficiary in his return for the year within or with which the taxable year of the estate or trust ends.[68] Thus, in selecting or changing the accounting period of an estate, trust, or beneficiary, you must consider not only the problems affecting taxable entities, but also the special problems which similarly arise in partnerships, estates, and trusts because of the analogous nature of their "distributive" income.

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[60] Note the conjunctive "capital *and* profits." Because of a recasting of the profit ratios in the resulting partnership, all the old partnerships might terminate.

[61] Again, because of the conjunctive, all of the "spun-off" partnerships may be new and the old partnership terminated. The application of the provisions discussed in this paragraph of the text are mandatory. A paragraph in the Senate bill giving the partnership a right to elect to be treated as continuing, even though under the statute it was considered to be terminated, was eliminated in conference. In the absence of court decisions, it would appear that these rules cannot be avoided either by agreements among the partners, or by resort to local law. In this connection, *see Burnet* v. *Harmel*, 287 U.S. 103 (1932), 11 AFTR 1085.

[62] The Supreme Court has sanctioned this result. *Guaranty Trust Co. of N.Y.* v. *Commissioner*, 303 U.S. 493 (1938), 20 AFTR 1043. This case involved the death of a partner and its result will not occur under the 1954 Code.

[63] *Anne Jacobs*, 7 T.C. 1481 (1946); *Louis Karch*, 8 T.C. 1327 (1947).

[64] Reg. 118 § 39.187-1.

[65] *Joseph Spatola*, 43 B.T.A. 1110 (1941). Annualization will further pyramid the income, but some relief is available under 1954 IRC § 443(b)(2), 1939 IRC § 47(c)(2).

[66] 1954 IRC § 641; 1939 IRC § 161.

[67] 1954 IRC §§ 651 to 668 inclusive; 1939 IRC § 162(b).

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[68] 1954 IRC § 662(c); 1939 IRC § 164.

16

Elections in Accounting Methods

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The Internal Revenue Code provides for various elections to be made by the taxpayer in regard to his tax accounting methods. Some of these elections have been present in the Code for many years. Others have been added by the 1954 Code. Knowing the available tax accounting elections and making timely use of them can often result in considerable tax savings.

1. Points to Consider

Taxpayers may make certain elections as to how and when to report income for taxation purposes.

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2. Elections in Reporting Income

The general rule is that taxable income must be determined on the basis of the taxpayer's method of accounting which is regularly employed in keeping his books.[1] If a regular method of accounting or if the method employed does not clearly reflect income, the taxable income shall be computed under such method as in the opinion of the Secretary or his delegate does clearly reflect the true taxable income.[2]

Although the Code and the Regulations do not prescribe a uniform method of accounting, the method employed by the taxpayer must clearly reflect income. The election as to the use of the method of accounting rests with the taxpayer alone and is exercised with the filing of the first federal income tax return. The method selected must be followed until permission is received from the Commissioner of Internal Revenue to change.[3]

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[1] 1954 IRC § 446(a); 1939 IRC § 41.

[2] 1954 IRC § 446(b); 1939 IRC § 41.

Items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used such amount is to be properly accounted for in a different period.[4] Deductions and credits are allowable in the taxable year which is the proper taxable year under the method of accounting employed.[5]

Subject to the provision that a taxpayer must keep his books on a method that clearly reflects income, the following permissible methods are set forth in the Code.[6]

1. Cash receipts and disbursement method:
2. Accrual method:
3. Any other method permitted by this section of the Code:
4. Combination of foregoing methods as permitted under regulations to be prescribed:

A taxpayer engaged in more than one trade or business may use a different method of accounting for each trade or business in computing taxable income.[7] Under the 1939 IRC taxpayers were required to use the same method of accounting in each trade or business, although there were numerous tax cases which held that different accounting methods could be used.

Taxpayers on the cash basis report as taxable income cash or property actually received during the taxable year, less proper deductions in cash or property actually paid or transferred during the year.[8] An exception to the rule occurs where the taxpayer may be taxable prior to the time of actual receipt on the theory of constructive receipt.[9]

The following advantages adhere to this basis of accounting:

1. Taxes not payable until cash has been received with which to pay them.
2. Possibilities of shifting income and deductions from one taxable period to another exist.
3. There is simplicity in record keeping, because no accruals are necessary.

Where transactions are numerous and complex, use of the cash basis of accounting is not practicable, because true income would not be reflected.

Where the cash basis of accounting is used, it must be followed uniformly as to both income and expenses, no variation from the basis being allowed.

In case of liquidation or where a business is sold, care should be exercised by cash-basis taxpayers to prepay all deductible items in order that the deduction will not be completely lost.

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[3] 1954 IRC § 446(c).

[4] 1954 IRC § 451(a); 1939 IRC § 42(a).

[5] 1954 IRC § 461(a); 1939 IRC § 43.

[6] 1954 IRC § 446(c); 1939 IRC § 41.

[7] 1954 IRC § 446(d).

[8] Reg. 118, § 39.44-2 and 3 (Regulations under 1939 IRC serve as stopgap regulations until others issued).

[9] Reg. 118, § 39.42-2.

The accrual basis of accounting is considered a more accurate and scientific method since it more nearly reflects the true income for any given period.

Under this method, income accrues and must be reported in the year during which all events have occurred which determine the right to receive it, even though such is to be received in a subsequent year. Deduction may be taken only in the year in which there must have occurred all events which fix the obligation to pay.

The accrual method has certain definite advantages over other methods in that it matches income items against related expenses.[10]

Accrual basis taxpayers claim deductions in the year in which "paid or accrued" or "paid or incurred."

The 1954 IRC recognizes that a taxpayer may have a hybrid method of accounting.[11] The use of such a method, subject to regulations to be issued by the Secretary or his delegate, must result in clear reflection of income. An example of a hybrid method of accounting is one where gross receipts and cost of sales are reported on the accrual basis and certain other classes of expenses such as selling and administrative are reported on a cash basis.

The installment method of accounting is actually a combination of the cash and accrual basis of accounting. This method is optional and it may be used by those who regularly sell personal property on the installment plan.[12] It may also be used in connection with the sale of realty or casual sales of personalty if the payments in the first year of the sale, referred to as initial payments, do not exceed thirty per cent of the total selling price. The 1939 IRC required a down payment in the year of sale, but under the 1954 IRC this provision has been eliminated.

The income to be reported for tax purposes in any taxable year is that proportion of the installment payments actually received in that year which the gross profit bears to the total contract price.

Deferred, installment, and unusual sales. The following table should be considered before deciding on the use of the installment method by persons other than installment dealers.

Use Installment Method	*Do Not Use Installment Method*
If lower income is expected in future years.	When taxpayer has losses. The law applies only to gains.
If you customarily avoid paying tax until income is collected.	When a taxpayer is building an installment business and the deferred income will put taxpayer in too high a tax bracket in later years.
If you expect declining tax rates.	When the capital gain law of the year in which collection is made will be disadvantageous. The law of the year of collection and not that of the year of sale is applied.
If you wish to spread present income over future years.	Partnerships should not use this method because death or dissolution of a partnership terminates the installment program.
If you desire to build up working capital by deferring the tax to later years.	All income remaining is taxed in the year of dissolution.

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[10] This method also gives a more even result in net income.

[11] 1954 IRC § 446(c)(4); 1939 IRC § 41.

[12] 1954 IRC § 453; 1939 IRC § 44(a).

The treatment of income from installment sales as ordinary income or as capital gain depends upon whether or not the property is sold as a capital asset.

In cases where the sale of property does not meet the tests of an installment sale, such a sale will be treated as a deferred payment sale, not on the installment plan, whether the taxpayer is on a cash or accrual basis. When so treated, the taxpayer will realize not only the amount received but also the fair market value of the vendee's obligations. All that is deferred is the amount by which the face value of the obligations exceed their fair market value. If the taxpayer takes obligations it is possible that they have no fair market value, but in these instances the burden of proof rests with the taxpayer. If no obligations or notes are accepted, but a mere contractual promise to pay over a period of time, no fair market value is present. Therefore, if the vendee is a good risk the profit may be more effectively deferred by not taking obligations or notes, but by reporting sale as a deferred payment sale even though it may qualify as an installment sale. The reason is that the profit from an installment sale is reported proportionately, whereas on a deferred payment sale the basis of the property is recovered before profit is reported.

Installment dealers. The Commissioner's permission is not necessary to adopt the installment method, but once adopted it cannot be abandoned without the consent of the Commissioner. Under the 1954 IRC, when a taxpayer on the accrual basis of accounting changes to the installment basis, certain adjustments should be made to eliminate double taxation of income.[13] That is, installment payments received in the year of change which had been previously reported are not excluded, but there is an adjustment in the tax payable for the year in which they are included for the second time. The tax in this year is reduced by the amount of tax attributable to the item in the first year, but not in excess of the amount of tax attributable to the item in the year in which it is included for the second time. The basis for determining the amount of tax attributable to an item is the ratio of gross profit to the gross income for such taxable year.

No special installment records are required. The books must merely be kept showing an accurate computation of income from installment sales. The receivables and collections should be separated and shown according to the year when the sale is made.

Expenses and other deductions are deducted in the year when paid (cash basis) or when incurred (accrued basis). They are not allocated to the years when income upon collection is reported.

When a purchaser defaults and the vendor repossesses the property sold, gain or loss for the year is computed upon any installment obligations of the purchaser, or applied by the vendor to the purchase of the property. Gain or loss is the difference between the fair market value of the property repossessed and the basis of the satisfied obligations. Adjustment is made for costs incurred in connection with the repossession. The repossessed property is carried on the books of the vendor at its fair market value at the time of repossession.

How to report income from long-term contracts. Taxpayers who derive income from contracts covering a period of more than one year from the date of execution to the date that the contracts are finally completed and accepted are permitted two special methods of reporting income—the percentage of completion basis and the completed contract basis.[14] Although these different bases are permissible, they are not mandatory. The cash or accrual basis may be used. The regulations state that the term "long-term contracts" means building, installation, or construction contracts.[15]

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[13] 1954 IRC § 453(c); 1939 IRC § 44(c).

While the Regulations refer to contracts of more than a year in duration, the courts have accepted this basis (even though the contracts were for less than a year) as long as the method has been consistently followed.[16]

To change from the cash or accrual method to either of the long-term contract methods, or vice versa, or from one of the long-term contract methods to the other, the permission of the Commissioner must be secured.[17]

Percentage of completion method. Under this method, gross income is reported according to the percentage of completion of the contract within the taxable year. The basis of determining percentage of completion is evidenced by certificates of architects or engineers, which should be attached to the tax return. When taxpayers have consistently followed this method without attaching certificates they have not been required to change their method of reporting.[18]

There should be deducted from gross income all expenditures made during the taxable year on account of the contracts, adjusted for materials and supplies on hand at the beginning and end of the taxable year for use in connection with the work under the contracts.

This method of reporting may result in the showing of a profit in a year when the contract is partially completed and a loss in another year. The net result will be the final profit and loss on the contract.

Completed contract method. According to this method the entire profit or loss is reported in the year in which the contract is finally completed, even though the taxpayer has not received the final payment.

In determining the income to be reported or expenditures to be deducted, disputed items are to be left out. Subsequent adjustments will result in profit or loss in the year in which settlement occurs.

Expenses in connection with contracts reported on the completed contract method are deductible only in the year in which the income is reported, rather than in the year in which they are paid or incurred.[19] General overhead expenses of a taxpayer reporting on this method must be allocated equitably to contracts completed during the year, and contracts incomplete at the end of the year.

3. Election as to Inventory Valuation Methods

In his first return, the taxpayer can elect that method of valuing inventory which conforms to the best accounting practice in the trade or business and which clearly reflects income. Among the methods usually elected are:

1. Cost
2. Lower of cost or market

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[14] I.T. 3251, 1939 C.B. 113.

[15] Reg. 118, § 39.42-4.

[16] *Harriet Borland*, 27 B.T.A. 538 (1932).

[17] O.D. 933, 4 C.B. 86.

[18] G.C.M. 22822, 1941-2 C.B. 126.

[19] Reg. 118, § 39.42-4(b).

Since cost can be measured by specific identification, by a first-in first-out basis or by an average cost basis,[20] the taxpayer can elect in his first return the method of measuring cost. Once these elections have been made they cannot be changed without permission of the Commissioner.[21] A farmer can elect in his first return to use the farm price method.[22] A dealer in securities can elect to use market value.[23] Retail vendors can elect to use the retail inventory method.[24] Miners and manufacturers can elect with consent of the Commissioner to use the "allocated cost" method of valuation when the inventory consists of several kinds, sizes or grades.[25]

The last-in first-out method of valuing inventory can be elected by the taxpayer upon approval of the commissioner.[26] Application to elect this method is made on Form 970 which is filed, in triplicate, with the tax return for the taxable year for which the method is first to be used.[27] This election is irrevocable.[28] A taxpayer on the LIFO method who suffers an involuntary liquidation of "low cost" inventory can elect to apply the relief provisions of Section 1321(a) of the 1954 IRC. This election is irrevocable for the year for which it is made.[29]

For detailed application of the effect of these elections, see Chapter 17, "How and Why to Take and Value Inventories."

4. Election as to Bad Debts

An accrual basis taxpayer can elect the specific bad debt method or the reserve bad debt method in filing the first return in which a bad debt deduction is claimed. Once elected, the method is binding for subsequent years.

A change from one basis to the other is a change in accounting method and therefore requires the permission of the Commissioner.

A cash basis taxpayer has no such election since he is required to use the actual bad debt method.

Cross reference: *See* Chapter 30, "How to Get Deductions for Bad Debts."

5. Election as to Depreciation Methods

Taxpayers entitled to deduct depreciation from their gross income can elect (1) to apply a single composite rate to all the depreciable assets, (2) to classify assets into groups as to use or as to useful life and apply an average rate to each group, or (3) to apply a separate rate to each itemized asset.[30] Taxpayers can elect to use:[31]

1. The straight line method

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[20] 1954 IRC § 471; 1939 IRC § 22(d).
[21] Reg. 118, § 39.41-2.
[22] Reg. 118, § 39.22(c)6.
[23] Reg. 118, § 39.22(c)5.
[24] Reg. 118, § 39.52(c)8.
[25] Reg. 118, § 39.22(c)7.
[26] 1954 IRC § 472(a); 1939 IRC § 22(d)(1), (3); Reg. 118, § 39.22(d)2.
[27] Reg. 118, § 39.22(d)3.
[28] Reg. 118, § 39.22(d)5.
[29] 1954 IRC § 1321; 1939 IRC § 22(d)(6)(D); Reg. 118, § 39.22(d)6(f).
[30] Bulletin F (revised January 1942).
[31] 1954 IRC § 167(b); I.T. 3818, 1946 2 C.B. 42.

2. Declining balance method using a rate not exceeding twice that allowable under the straight line method
3. The sum of the years-digits method
4. Any other consistent method, which does not, during the first two-thirds of the useful life, give an allowance which would be greater than that allowable under method two set forth above.

In order to obtain the benefits of the methods set forth in (2), (3) and (4) above, the assets must be acquired after December 31, 1953, must have a useful life of at least three years and its original use commence with the taxpayer.[32]

Taxpayers must continue to depreciate assets acquired before December 31, 1953 on the same method as they had been using and cannot change without permission of the Commissioner. For assets acquired after December 31, 1953, a separate election for each year's acquisitions can be made.

Cross reference: *See* Chapter 29, "How to Get Maximum Deductions for Depreciation."

6. Election as to Amortization of Emergency Facilities

Taxpayers having an emergency facility meeting the definition of 168(d)(1) IRC can elect to amortize the cost of these facilities during a period of sixty months instead of during the useful life. This election can be made effective in the month following or in the year following the completion of the facility.[33] This election is made by a statement to that effect in the return for the taxable year in which falls the first months of the 60-month amortization period.

The taxpayer can also elect to discontinue the amortization of an emergency facility by filing a notice in writing with the Commissioner before the month in which the discontinuance is to be effective.

7. Election as to Grain-Storage Facilities

A taxpayer who constructs, reconstructs or erects a grain-storage facility between the period of December 31, 1952 and January 1, 1957, may at his election, amortize the cost over a sixty months period.[34] This election can be made effective in the month following or in the year following the completion of the facility. The election of the taxpayer shall be made by filing a statement to that effect in the return for the taxable year in which the facility was acquired.

The taxpayer can also elect to discontinue the amortization by filing a notice in writing with the Commissioner before the month in which the discontinuance is to be effective.

8. Election as to Amortization Bond Premiums

Any taxpayer can elect to amortize bond premiums on wholly taxable obligations. The amortizable bond premium is deductible from gross income and must be used to reduce the basis of the security. A noncorporate taxpayer can elect to amortize bond premiums on partially tax-exempt obligations.[35]

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[32] 1954 IRC § 167(c).
[33] 1954 IRC § 168(b); 1939 IRC § 124-A(b).
[34] 1954 IRC § 169; 1939 IRC § 23(t), 124B(a).

The election is made by the taxpayer claiming the deduction in the first taxable year in which he desires the election to be applicable. The election applies to all bonds owned and is binding for future years. It can be revoked by permission of the Commissioner.

It is compulsory for all taxpayers to amortize bond premiums on wholly tax exempt bonds, even though the amortization results in no tax deduction.

9. Election as to Certain Deferrable Expenditures

There is an election as to the treatment of certain types of deferrable expenditures. The various types of expenditures are set forth below:

1. Carrying charges
2. Circulation expenditures
3. Mine development expenditures

a. Carrying charges. Under certain conditions taxpayers may elect either to deduct or capitalize certain expenditures such as taxes, interest, and other carrying charges.[36] When the election to treat these expenditures one way or the other has been made, it must be followed until the project has been completed.

The opportunity to make this election is present in the following cases:

1. *Unimproved and unproductive real property.* Election to deduct or capitalize taxes, interest, and other carrying charges.

2. *Real property being developed or improved.* Election to deduct or capitalize costs up to the time construction or development has been completed; such as, interest on construction loans, social security taxes on own employees, sale or use taxes on materials used in development or improvement of property and other necessary expenditures paid or incurred in connection with this work.

3. *Personal property.* Election to deduct or capitalize interest on loans to purchase such property or to pay for transporting or installing, sales and use taxes paid on the property, social security taxes on own employees used in transporting and installing such property, paid or incurred up to the date installed or first put into use, whichever date is later.

If the taxpayer elects to capitalize any item or items, his election shall be exercised by filing with the original return a statement setting forth the item or items which are being treated as chargeable to capital.[37] Permission of the Commissioner is not necessary.

b. Circulation expenditures. Publisher may elect to capitalize, rather than deduct, expenditures made in an effort to establish or to increase circulation. Any expenditures made from year to year to maintain circulation may not be capitalized, but must be treated as deductible expense.[38]

If the election is made, it must apply to all expenditures in connection with increasing circulation for the present and subsequent taxable years, unless the Commissioner grants a change on written application by the taxpayer. The election is made by attaching a statement to the first tax return to which it is applicable.

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[35] 1954 IRC § 171; 1939 IRC § 125(cc).
[36] 1954 IRC § 266; Reg. 118, § 39.24-5.
[37] Reg. 118, § 39.24-5(c).
[38] 1954 IRC § 173; 1939 IRC § 23(bb).

c. Mine development expenditures. For taxable years ending before December 31, 1950, a taxpayer was required to capitalize all mine development expenditures that were in excess of net receipts from minerals sold and these expenditures were recoverable through depletion charges. On reaching production, development expenditures were treated as a current deduction.

The Revenue Act of 1951 and also the 1954 IRC grants an election as to the treatment of certain development expenditures.[39] These expenditures may be deducted in the year paid or incurred or they may be deferred and deducted ratably over the units of ore produced or minerals benefited by such expenditures. In the case of a mine in the development stage, the election shall apply only to the excess of expenditures over the net receipts from ores or minerals produced during such year.

If the election is made, it must apply to all expenditures for development. The election is made by a written statement filed with the Director of Internal Revenue with whom the return is filed or by a rider attached to the return.

10. Election as to Contributions

Generally a taxpayer either on the cash or the accrual basis can only deduct a contribution when it is paid. But in the case of a corporation reporting on the accrual basis, an election may be made to accrue a charitable contribution. The contribution must be paid on or before the 15th day of the third month following the close of the taxable year in order to get a deduction. Such contribution must be authorized by a resolution of the board of directors before the close of the taxable year.[40] The election shall be made at the time of filing the tax return. A certified copy of the resolution of the board of directors should accompany the tax return.

11. Election as to Exploration Expenditures

Expenditures paid or incurred to ascertain the existence, location, extent, or quality of any deposit of ore or other mineral before the beginning of the development stage are deductible up to $100,000 in any taxable year.[41] The taxpayer may elect, as to such expenses up to $100,000, to treat them as deferred expenses and deduct them ratably as the ore or mineral is sold. The election is not binding on future years.

12. Election as to Organizational Expenses

Prior to the passage of the 1954 IRC, organizational expenses were only deductible in the year of dissolution, unless the charter of the corporation was for a limited period in which case they could be amortized over the life of the charter.

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[39] 1954 IRC § 616; 1939 IRC § 23(cc).
[40] 1954 IRC § 170(a)(2); 1939 IRC § 23(9).
[41] 1954 IRC § 615; 1939 IRC § 23(ff).

The 1954 IRC allows, at the election of a corporation, to treat such expenditures as deferred expenses.[42] If the election is made the write-off is taken ratably over a 60 months period or more, beginning with the month the corporation began business. The election may be made for any taxable year beginning after December 31, 1953, but only applies to organizational expenditures incurred after August 16, 1954.

The election shall be made by a statement attached to the taxpayer's return and must be filed not later than the date prescribed by law for filing the return for the year in which the election is made.

The statement should show the following:

1. Description of expenditures;
2. Amount of expenditures; and
3. The number of months over which such expenditures are to be deducted ratably.

13. Election as to Research and Experimental Expenses

Taxpayers may treat research and experimental expenses which are not capital in nature as current expense or they may elect to treat them as deferred expense. If the expenses are deducted currently all research and experimental expenses must be included and this method consistently followed unless permission to change is granted by the Commissioner.[43] If the election is made to defer these expenditures it must likewise apply to all such expense and must be consistently followed. The election must be made no later than the time for filing the return for the year in which the expenditures were paid or incurred.

The election shall be made by a statement attached to the taxpayer's return for the first taxable year and should show the following:

1. Amount of each type of such expenditure;
2. Description of the nature of such expenditure; and
3. The period over which such expenditure is to be ratably deducted.

14. Election as to Soil and Water Conservation Expenditures

Taxpayers engaged in farming can deduct in the year paid or incurred, expenditures for soil and water conservation or erosion of land.[44] If these expenditures are not deducted currently they are capitalized.

The current expense method may be elected for taxable years beginning after December 31, 1953 and which end after August 16, 1954. Once adopted the method must be adhered to for subsequent taxable years unless authorized by the Commissioner to change. No consent is required when adopting the method for the first time.

The election shall be made by a statement attached to the taxpayer's return and shall specify each type of expenditure and describe them in detail.

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[42] 1954 IRC § 248.

[43] 1954 IRC § 174.

[44] 1954 IRC § 175.

15. Election as to War Loss Recoveries

Taxpayers having a recovery in the taxable year for property deducted as a war loss under the provisions of Section 1331 of the Code have an election, under certain conditions, as to the treatment of the recovery. The taxpayer can consider the recovery as income in the year received to the extent that the loss resulted in tax benefit or the taxpayer can elect to adjust the year of the loss by the amount of the recovery. If the adjusted basis of the property at the date of loss exceeds the recovery, then the tax for the year of loss is recomputed after netting the recovery against the adjusted basis.

If the recovery equals or exceeds the adjusted basis, then the excess is considered as gain on the involuntary conversion of property. The election, irrevocable once made, is binding on future recoveries.[45] The election, applicable to taxable years beginning after December 31, 1941, is irrevocable.

16. Election as to Real Property Taxes

Previous to the enactment of the 1954 IRC real property taxes were deductible only at the time they became a lien against the property. For taxable years beginning after December 31, 1953 and ending after August 16, 1954, taxpayers on accrual method of accounting may elect to accrue property taxes ratably over the period which the tax relates.[46]

The accrual method may be adopted without consent in the first taxable year, provided that the election is made no later than the due date of the return for the taxable year. Adoption after the first year requires approval of the Commissioner.

The election shall be made by a statement attached to the taxpayer's return for the first taxable year and should set forth the following:

1. Method of accounting used by taxpayer; and
2. The period of time to which the taxes are related.

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[45] 1954 IRC 1331; 1939 IRC § 127(c) and 1954 IRC § 1335; 1939 IRC § 127(c)(5).

[46] 1954 IRC § 461(c).

17

How and Why to Take and Value Inventories

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The question of what is the best way to take and calculate the inventory, a task that often concerns a taxpayer's most sizable current asset, is a very serious one. The manner of taking inventory may determine whether high profits will be taxed in the highest tax rate years, or whether they will be taxed, later, at lower rates. The taxpayer (1) may give effect to a falling market, (2) may freeze his profit margin at a constant level, (3) may take into consideration obsolete goods or numerous other factors. If these points are carefully evaluated, they may assist greatly in intelligent tax planning. The problem is discussed in this chapter.

1. Points to Consider

First, you must decide whether or not you must take inventories.[1] If the production, purchase, or sale of merchandise is an income-producing factor, it is self-evident that the allocation of income to the period in which it is earned is not possible without the computation of inventories.[2] If you decide that inventories are necessary you must determine:

	Section
What goods must be included in the inventory?	2
Which is more important, consistency or strict correctness?	3
What constitutes conformity to best practice?	4

Having decided these questions, you must then consider the generally acceptable methods of computing inventories and choose the most suitable one. These methods are:

1. Cost
2. Cost or market, whichever is lower
3. Market, in the case of dealers in securities
4. Farm-price method

The taxpayer's method of taking inventory must be elected in his return and may not be changed without securing permission from the Commissioner.[3]

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[1] 1954 IRC § 471; 1939 IRC § 22(c). Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

[2] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-1.

[3] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-2.

A discussion of the cost method of taking inventory is presented as follows:

	Section
Definition of cost	5
Treatment of obsolete and unsalable goods	6
Cost on "first-in, first-out" basis	7
Cost on "last-in, first-out" basis	8
Cost on retail method	9
Cost on other bases	10
Treatment of second hand and unsalable goods in cost inventory	11

A discussion of the lower of cost or market method of taking inventory is presented as follows:

	Section
Definition of lower of cost or market	12
Determination of market	13
Reproductive cost when there is no market	14

2. Goods to be Included in the Inventory[4]

Goods to be included in the inventory are those that are acquired for sale or that will physically become a part of the merchandise intended for sale.[5] Title to the goods must be vested in you.[6] The question of includability in your inventory may arise in the following cases:

a. Goods on consignment. These should be included in the inventory of the consignor. The existence of the consignment may be determined from examination of all evidence tending to reflect the apparent understanding of the parties.[7] Such evidence may consist of correspondence, billing, or the manner of accounting.

b. Goods in transit. The terms of the sale determine includability, because they indicate the point at which the title to the goods passes. The purchaser should include the goods in his inventory if the title passes at the loading point, or at the place of purchase. Goods shipped F.O.B. destination are includable in the purchaser's inventory only when they reach his hands.[8]

c. Goods set aside or appropriated for use of the purchaser in the warehouse of the vendor. An example may be found in the case of the woolen manufacturers, who sometimes purchase substantial lots of wool, which are set aside for the account of the purchaser in the warehouse of the seller. Such goods are properly taken into the purchaser's inventory, since they are likewise included in his purchases account.

d. Merchandise in the hands of a processor. This is inventoried by the owner when the goods are to be returned in kind. But when a new product is returned, such as the return of copper for ore, or flour for wheat, the goods are not inventoried, since this constitutes an exchange.[9]

e. Goods shipped on approval. These should be included in the seller's inventory until accepted.[10]

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[4] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-1.

[5] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-1.

[6] *Ibid.*

[7] *Ibid.*

[8] *Henry R. Fishel,* 14 B.T.A. 87 (1928).

[9] S.M. 1313; 2 C.B. 45.

[10] *Cleveland Woolen Mills,* 8 B.T.A. 49 (1927).

f. Goods under contract of sale but not yet segregated and applied to the contract. Such goods are to be included in the inventory of the seller, since title has not passed by appropriation of the goods to the purchaser.[11]

g. Samples, subject to inspection and rejection within a specified time.[12] Samples of this type are includable in the inventory of the seller, if they are promptly rejected by the buyer.

h. Goods rejected because of defects. These are includable in the seller's inventory if the buyer's rejection is timely.[13]

i. Operating supplies or property not intended to be sold and not becoming a part of the cost of goods sold. These may be omitted from the inventory and treated as deferred charges, to be deducted as they are used or consumed.

3. Consistency in Method[14]

Consistency in method from year to year is highly desirable in the determination of an inventory.[15] Consistency of method does not, however, justify the perpetuation of gross error. The treatment of inventory items should be uniform in the opening and closing inventory, but erroneous practices should not be continued on that account. Undoubtedly, many costs may be treated on alternative bases, provided the method is followed consistently. However, certain basic elements must be included under any circumstances:

1. Cost (or market) of materials
2. Labor and overhead applicable to goods in process and finished goods

The items of overhead may vary in different cases. For example, duties may be included or omitted, provided a consistent practice is followed. There are many methods of applying labor and overhead. There is no hard and fast rule concerning the method to be used, but some suitable or recognized basis must be applied consistently. Labor and overhead items are not to include advertising and selling expenses.

4. Conformity to Best Practice[16]

Best accounting practice in a trade, as it applies to inventory valuation, embraces those methods followed by persons in the industry best informed on the question. The practices of such leaders in the industry, recommendations of trade journals, and writings on the subject may indicate the treatment that may be appropriate under given circumstances. The best practice in the industry constitutes the standard to be attained. Improper methods of valuation that may have grown up in a particular locality should not be a guide.

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[11] 1954 IRC § 471; 1939 IRC § 322(c); Reg. 118 § 39.22(c)-1.

[12] *Florence Mills, Inc.*, 9 B.T.A. 579 (1927).

[13] *Ibid.*

[14] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-2.

[15] *Bus Company*, 2 B.T.A. 266 (1925); *Huntington Securities Corp.* v. *Busey* (6 Cir. 1940), 112 F. 2d 368, 25 AFTR 82; *Chicago Frog & Switch Co.*, 68 Ct. Cl. 186 (1926), 7 AFTR 9141; *Rookwood Pottery Co.* v. *Commissioner* (6 Cir. 1930), 45 F. 2d 43, 9 AFTR 499.

[16] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-2.

5. Definition of Cost (What It Includes)

The Regulations, which strictly control all inventory calculations, should be carefully followed in computing an inventory at cost.[17] In the case of raw materials, the cost will embrace:

1. Invoice price of goods, and
2. Freight and transportation charges.[18]
3. Duties. (May be added on imported products, if consistently done.)[19]
4. Interest. (That interest paid on funds borrowed to carry an inventory may be included at the option of the taxpayer.)

Cost may be reduced by:

1. Trade or other discounts
2. Strictly cash discounts at the option of the taxpayer, provided a consistent course is followed.

Cash or trade discounts.[20] Trade discounts are properly deductible from cost of raw materials. Cash discounts are deductible at the option of the taxpayer, but the election, once made, must consistently be followed. The type of discount, whether cash or trade, is to be determined in the light of all the evidence.[21]

Cost: Goods in process and finished goods.[22] The following factors should be considered in valuing an inventory of goods in process and finished goods, at cost:

1. The cost of raw materials and supplies entering into or consumed in the creation of the product.
2. Direct labor costs.
3. Indirect expenses incident to and necessary for production.

These expenses should include a reasonable portion of manufacturing expenses and overhead, but not sales expense or interest.

The section of the Regulations governing valuation of goods in process and finished goods inventories is very broad and extremely flexible. It requires that you look to the best practice in your trade or industry in the solution of your problems. There are many methods of applying labor and overhead that you may find to be equally acceptable, and the choice may be governed by practicability. It may be accomplished by a standard cost system, based on time studies carefully brought up to date. However, this is rarely possible. Information on the subject may be obtained from trade journals and trade association studies. In any event, the practice followed must be the industry's best, not merely a procedure prevalent in the area. Errors to be avoided in a manufacturing establishment's inventory are:[23]

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[17] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-3. *Sackstein et al.*, 14 T.C. 566 (1950); *Montreal Mining Co.* (6 Cir. 1944), 33 AFTR 1660.

[18] *McIntosh Mills*, 9 B.T.A. 301 (1927); *Denning & Co.*, 7 T.C.M. 980 (1948).

[19] A.R.R. 140, 2 C.B. 55.

[20] *Thomas Shoe Company*, 1 B.T.A. 124 (1924).

[21] *Warfield-Pratt-Howell Company*, 13 B.T.A. 305 (1928).

[22] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-3; *Frank G. Wikstrom & Sons*, 20 T.C. 45 (1953).

[23] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-2.

1. Valuation of finished goods and goods in process at standard figures, without undertaking to verify their correctness;
2. Use of arbitrary figures bearing no relation at any time to the cost of goods;
3. Taking an arbitrary markdown from the sales price to inventory value without regard to markup.

The Bureau has often treated goods in process as half complete, considering that a unit of such goods should have apportioned to it one-half the amount of labor and overhead allocated to a finished unit.[24] However, it may be more desirable to apply the rule on a more scientific basis, if this can be done. It may be apportioned to the goods on the basis of a standard cost system, in accordance with a formula acceptable to the trade generally, in proportion to the application of direct labor, or on any of the other recognized bases that are consistently followed.

Certain waste factors, the use of which is based on the experience of the taxpayer, may be applied in determining the raw material content of the goods in process and of finished goods. This content may vary in different plants or mills. The receipts from waste sales may be treated either as a separate item of income, or may be applied to reduce the cost of goods manufactured.

6. Obsolete or Unsalable Goods[25]

These may be included in the inventory at scrap value under both the "cost" and the "lower of cost or market" methods. To do this, you must show that the goods are different from those regularly included in this inventory.

Defective or sub-standard goods.[26] Such goods may be valued at sales price, less cost of disposition. Used motor car inventories, for example, may be valued by adding to the trade-in allowance, the cost of reconditioning, and then subtracting the cost of selling.

7. Cost on a First-in, First-out Basis[27]

When goods in an inventory have been purchased at many different dates the impossibility of identifying specific lots is apparent, especially when they are a mass of bulk or fungible goods. As a result, certain theories concerning acquisition dates have been applied in such cases.

The "first-in, first-out" method has the sanction of the Regulations, and is the most logical general basis of computing a cost inventory. It follows the theory that the first goods acquired are the first sold. This is an example of the manner in which it operates:

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[24] *Avon Mills*, 7 B.T.A. 143 (1927).

[25] *Tucker* v. *U.S.* (Ct. Cl. 1931), 53 F. 2d 418, 10 AFTR 664; *Cleveland Automobile Co.* v. *U.S.*, 70 F. 2d 365, 13 AFTR 986 (1934); *Knowlton Brothers* v. *U.S.* (Ct. Cl. 1944), 53 F. Supp. 221, 32 AFTR 73.

[26] *Lord Motor Co.* 5 B.T.A. 818 (1926); *Pierce-Arrow Motor Co.* v. *U.S.* (Ct. Cl. 1935), 11 F. Supp. 161, 16 AFTR 282.

[27] *Lucas* v. *Kansas City Structural Steel Co.*, 281 U.S. 264, 50 Sup. Ct. 1930, 8 AFTR 10897.

UNITS OF "A" PURCHASED BY TAXPAYERS

Date Purchased	Number	Price	Total cost
January 10, 1948	10 units	$1.00	$10.00
February 18, 1948	10 units	1.10	11.00
March 14, 1948	10 units	1.20	12.00
August 31, 1948	15 units	1.25	18.75
December 15, 1948	10 units	1.30	13.00
Total	55 units	......	$64.75
Inventory of "A" on hand at January 1, 1948	25 units	$1.00	25.00
			$89.75

There are on hand at December 31, 1948, 25 units that cannot be specifically identified. These are valued as follows:

10 units	$1.30	$13.00
15 units	1.25	18.75
Inventory at December 31, 1948		$31.75

The cost of the 55 units sold is, therefore, $58.00 ($89.75 minus $31.75). Had the specific lots been identifiable, and if the inventory at the first of the year, the last two purchases of the year, and five of the March 15 purchases had been sold:

Date Purchased	Number	Price	Total cost
January 10, 1948	10 units	$1.00	$10.00
February 18, 1948	10 units	1.10	11.00
March 15, 1948	5 units	1.20	6.00
Total	25 units	......	$27.00

The cost of the units on this specific lot basis would be, therefore, $62.75 ($89.75 minus $27).

The use of the "first-in, first-out" basis charges out the oldest costs first, and assumes that the latest are in the inventory. It is apparent that, in time of rising prices, this method results in the taxation of unrealized profit, since income is increased by the higher costs, whereas the lower costs, sustained at an earlier date, are charged against the sales of the period.

8. Cost on a "Last-in, First-out" Basis[28]

This method is somewhat similar to the "base stock" method, which was rejected by the courts. Its use was extended by the 1939 Act to all taxpayers electing it in their tax returns, with the result that it has become known as the "elective" method. Following this theory, the goods acquired last are regarded as having been sold first. As a beginning point, the opening inventory is frozen at cost. Therefore, if the goods have been valued at the lower of cost or market at the end of the preceding year, a substantial adjustment may result. The price is thus fixed at the level of the preceding year, and equal quantities on hand in the current year's inventory are to be valued at this basic price.[29] The excess over the quantities in the preceding year's inventory will be valued, at the election of the taxpayer, on one of the following bases:

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[28] 1954 IRC § 472(a) and (b); 1939 IRC § 22(d)-1; Reg. 118 § 39.22(d)-1.

1. The cost of the year's first acquisitions
2. The average cost of the year's acquisitions
3. The cost of the last acquisitions

Following the example previously used, let us assume that the taxpayer purchased units of "A" as noted in the table on page 290.

Assuming that 55 units had been sold during the year, the goods still on hand would be priced at $1 per unit, the amount of the frozen price, or a total of $25. The cost of goods sold on the "last-in, first-out," or LIFO, basis is, therefore, $64.75, as compared with $58 on a FIFO basis. If the closing inventory had included 35 units and the taxpayer elected to value the excess on the basis of first acquisition, the inventory would be $35, taking into account the 25 units on hand January 1, 1948, and the 10 units acquired on January 10, 1948.

The LIFO method of computing cost is particularly suited to industries processing large quantities of bulk goods. The valuation in such cases is usually accomplished by reducing the inventories to their basic raw material content, and then comparing the raw material content in the closing inventory (raw materials, goods in process, and finished goods) with that in the opening inventory. The equivalent quantities in the closing inventory are valued at the frozen price units in the opening inventory, whereas the excess over these units is valued at either the first acquisition price for the year, the average acquisition price, or the last acquisition price. For example, assume the following content of raw material "A":

In Inventory on December 31, 1947	Units of "A"
Raw material	100
Goods in process	100
Finished goods	100
Total Units	300

@ $1 per unit

In Inventory on December 31, 1948	Units of "A"
Raw material	100
Goods in process	100
Finished goods	125
Total Units	325

300 of these units would be valued at $1 per unit. Assuming the first acquisitions for the year cost $1.10, the other 25 would be valued at this price, or $27.50 (assuming this method of valuation of the excess was elected). The total cost of raw materials in the closing inventory would then be $327.50, on the LIFO basis.

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[29] 1954 IRC § 472(c); 1939 IRC § 22(d)-2; Reg. 118 § 39.22(d)-2; *Edgar A. Basse, et al.*, 10 T.C. 328 (1948), *Sweeney & Co., Inc.*, 7 T.C.M. 121 (1948).

The Regulations present a rather comprehensive discussion of the application of this method, and undertake a solution to particular problems arising in certain industries.[30] They deal, for example, with the difficult question of grouping materials for the application of the price unit in the cotton textile industry. They provide that where staple lengths or grades of cotton are being used at different times in the same mill to produce the same class of goods, such variance in use does not necessarily require the classification of the materials into different raw materials. Under such circumstances, all of the cotton may be included as "cotton." A further example presented is taken from the pork packing industry. The Regulations explain that a live hog is considered as being composed of various raw materials, different cuts of a hog varying markedly in price and use. Generally, a hog is processed into approximately ten prime cuts and several miscellaneous articles. Because of similarity in price and use, these may be grouped into further classifications, each group being classed as one material.

The taxpayer may limit election to raw material, including raw material entering into goods in process and into finished goods. It may also be limited to that phase of manufacturing processes where a product is produced that is recognized generally as a salable product. For example, in the textile industry one phase of the process is the production of yarn. Since yarn is generally recognized as a salable product, the election may be limited to that portion of the process wherein yarn is produced. In the case of copper and brass processors, the election may be applied to the production of bars, plates, sheets, and so forth, although these may be further processed into other products. This election may also apply to any one raw material when one or more raw materials enter into the composition of the finished product. For example, in the case of cotton cloth and cotton yarn, the taxpayer may elect as to the inventory of the cotton content only. However, a taxpayer who has previously chosen to use the elective inventory method may not later elect to exclude any raw materials that were covered by some previous election.

The method has been allowed to department stores, computed on a dollar unit basis by departments, using a price index.[31]

Qualification to use the method.[32] The taxpayer must comply with the Regulations bearing on the subject if he wishes to be allowed to use this method. The election to use it is made in the taxpayer's return. An analysis of the inventory for the current year and for the two preceding years must be submitted attached to a form on which the election is made. This form, which is submitted with the tax return, describes the goods to which the taxpayer elects to apply the method. Disqualification will result if statements are issued to partners, to stockholders, or for credit purposes on an annual basis, using another inventory method. Interim statements, using other inventory methods, are permitted, however.

Effect of using LIFO. The effect of the method is to value goods at stable lower prices in order to prevent the taxation in high tax years of income that will later be taxed when the inventory shrinks. A great tax saving may be effected if the method is elected when prices are rising, inventories expanding, and tax rates increasing. The opposite is true if it is elected at the wrong time. Since it charges the latest costs against current sales prices, it has been widely heralded as a method of eliminating "false profits." However, before it is elected, test calculations covering several succeeding years should be made. The computations should be based on reasonable assumptions concerning prices, income, and tax rates, in an effort to anticipate the possible results of the method.

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[30] 1954 IRC § 472(a) and (b); 1939 IRC § 22(d)-1; Reg. 118 § 39.22(d)-1.

[31] *Hutzler Bros.* 8 T.C. 14 (1947); *Edgar A. Basse,* 10 T.C. 328 (1948).

[32] 1954 IRC § 472(a); 1939 IRC § 22(d)-3; Reg. 118 § 39.22(d)-3.

The great objection to its use is its general unwieldiness and the complexity of the calculations that are sometimes necessary, as well as the limitations imposed on methods of financial reporting. Operating managers often dislike the more conservative reporting of results, which may compare unfavorably with those of a similarly situated enterprise, reporting on a "first-in, first-out" basis.

A corporation, inventorying goods on the LIFO basis, that contemplates a distribution of inventory assets as a dividend, or in liquidation of its stock, should carefully consider this matter. The 1954[33] Internal Revenue Code provides that where this is done, the difference between the LIFO basis of the inventory and its value when calculated on a conventional basis may be taxed as ordinary income to the corporation.

9. Retail Method

The retail method is another variation of cost; or if computed in a certain manner, it can be regarded as a variation of the lower of cost or market method. By considering the markups and markdowns and making an elimination therefor, it provides a short cut method of arriving at the approximate cost of the inventory with a minimum of clerical work.

The retail merchant may employ the retail method of pricing inventories, provided that the use of the method is designated on the return, and that current accounts are kept for it and are consistently followed. Accurate records should be kept by departments in permanent form, available for the inspection of the internal revenue agents. Purchase records should show the firm from whom purchased, the date of invoice, invoice cost, and retail sales price. Also, all subsequent markups and markdowns should be recorded.

Under this method, the goods are priced at selling prices, and the total retail value is reduced to approximate cost by deducting the percentage that represents the difference between the retail selling price and the purchase price. Two prices should therefore be recorded, invoice price, plus transportation, and original retail price. The total purchase markup for the period is computed as follows:

1. Opening inventory at sales price, plus purchases at sales price = (a).
2. Opening inventory and purchases at cost, plus transportation = (b).
3. The difference between (a) and (b) = (c).
4. (c) divided by (a) = Percentage.

This percentage is applied to the sales price of the goods in the closing inventory. If there have been various markups and markdowns applied to the sales price, these should be accounted for.

In arriving at the percentage to be applied to the closing inventory, markdowns may be ignored, if this practice is consistently followed. The effect of failing to consider the markdowns may be the computation of the inventory at approximately the lower of cost or market.

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[33] 1954 IRC § 311(b).

LIFO variation of retail method. The Tax Court has allowed the computation of a department store inventory on a LIFO variation of the retail method. Admittedly, it is a physical impossibility to match items in the opening inventory with those in the closing inventory, because of the multiplied thousands of different types and varieties of goods in a department store. The theory followed in the computation is the use of a dollar unit, making the calculation separately for each department, thus treating the goods of that department as fungible, even though they are of many types. In the case of a manufacturing establishment, the theory requires the comparison of units in the opening and closing inventory, such as the pricing of 100 units of "A" in the closing inventory at the cost of 100 units of "A" in the opening inventory, whereas the department store computes the inventory on this basis by comparing the $15,000 at retail in Department "A" in the closing inventory with the $10,000 at retail in the opening inventory. However, to make the comparison properly, it is necessary that the $15,000 in the closing inventory be reduced to approximately the sales price of these goods at the end of the preceding year. Therefore, the goods in the particular department in the closing inventory are reduced by the use of a recognized price index, so that these will be priced on the basis of the preceding year.[34] Indices published by the United States Bureau of Labor Statistics are considered acceptable by the Commissioner. If the index used for the purposes indicates that there has been an increase between the years of 25 per cent, the $15,000 would be reduced by dividing it by 1.25. This indicates that the same goods would have been priced at $12,000 at the end of the preceding year. This $12,000 is then compared with the $10,000 shown in the closing inventory of the preceding year. $10,000 would thus be considered to be priced at the frozen price. The other $2,000 would be marked back to the current year's prices and the inventory value determined by eliminating the markups in the usual manner of computing retail inventories. If, for example, an index showed 150 at the end of 1948 and 135 at the end of 1947, the sales price could be divided by 150 and multiplied by 135 to arrive at the price for comparison with the 1947 prices on the LIFO basis.

The term "department store" has been broadened to include a "specialty store."[35] This permits the "specialty store" to use the department store method of computing inventories on a LIFO basis by the application of the same price indices as those used by department stores if the specialty store's inventory is reasonably similar to those carried by department stores.

One of the disadvantages of the LIFO inventory method grows out of the involuntary liquidation of the base stock inventory[36] because of the inability to obtain the goods necessary to keep it up to the desired level. This may result in the elimination of the lower priced stock and the substitution of goods acquired later at a high price, which may prove injurious when considered from a tax standpoint. For example, assume that the inventory as of December 31, 1949 contained 100 units of A valued at $1 per unit. At the end of 1950, these units might cost $1.50 each; however, if enough are on hand to equal the amount contained in the inventory at December 31, 1949, the inventory would be considered on the same basis as that used in determining its value at December 31, 1949. Consequently, the charge to "purchases" for materials is $1.50 while the value at which these same materials are included in the inventory is $1, resulting in a net tax deduction of $.50 per unit in the year 1950. If these units should not be replaced at the end of 1950, but were acquired in 1951, they would cost $1.50 each and be taken into the inventory at the cost of the year's first acquisitions, or $1.50. As a result, the $.50 per unit deduction that would result had they been replaced at the end of 1950 is lost to the taxpayer.

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[34] 1954 IRC § 472(a) and (b); 1939 IRC § 22(d)-1; Reg. 118 § 39.22(d)-1.

[35] Rev. Rul. 23 IRB 153-56.

[36] 1954 IRC § 1321(a)(b) and (c); 1939 IRC § 22(d)(6)(F)(i)(ii) and (iii).

If for any taxable year ending after June 30, 1950 and prior to January 1, 1955, such a decrease in the base stock inventory occurs, the law contains relief provisions, provided that this grows directly and exclusively from one of the following reasons:

1. Enemy capture or control of limited foreign supply.
2. Shipping or other transportation shortages.
3. Material shortages resulting from priorities or allocations.
4. Labor shortages.
5. Other prevailing war conditions beyond the control of the taxpayer.

The terms "enemy" and "war" are to be interpreted pursuant to the regulations prescribed by the Secretary in such a way as to apply to circumstances and conditions which are similar to those set forth above if they grow out of the National Preparedness Program.

If this section is invoked, an election to claim its benefits should be made in the tax return of the taxpayer. This permits the taxpayer, if the goods are replaced in a year ending prior to January 1, 1956, to recompute the inventories and the taxes for the year of the involuntary liquidation and of all intervening years up to the year of replacement, so that they will be the same as those that would have been paid if the reduction in the base stock inventory had not occurred.

Other methods of computing cost. On a few rare occasions it is possible to effect specific identification of articles and to inventory on this basis.

In the case of miners and manufacturers, who by a single process produce two or more sizes or grades of products, the unit cost of which is substantially alike, the cost may be allocated between the products in accordance with established practice in the industry.

Also, in a case having to do with the valuation of finished inventories, a taxpayer was permitted to deduct from the finished goods a percentage of markup in order to arrive at its estimated cost. However, in this case a more exact determination was not possible because of inadequate cost records.[37]

10. Definition of Lower of Cost or Market

In determining inventory at the lower of cost or market, the following goods should first be eliminated, since they are accorded separate treatment:

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[37] *Lundborg & Co., Inc.* v. *White* (D.C. Mass. 1933), 3 F. Supp. 611, 12 AFTR 1018.

1. Goods covered by firm sales contracts.[38]
2. Obsolete and unsalable goods.
3. Substandard goods.
4. Goods covered by firm sales contracts (not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which you are protected against actual loss, must be inventoried at cost.
5. Obsolete goods should be inventoried at scrap value.
6. Substandard goods should be inventoried at estimated sales price, less cost of disposition.
7. Both obsolete goods and substandard goods are treated in the same manner as under the cost method.
8. The inventory should then be valued by listing the goods at cost and at market, item by item, or in reasonable classifications, taking the lower in each instance. The market price is the amount that would be paid for the goods in the quantities usually purchased by the taxpayer.

11. Determination of Market

When an open market does not exist, or where quotations are nominal because of stagnant market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory valuation date as is available. These should be specified purchases or sales made by the taxpayer or others in good faith or compensation paid for the cancellation of contracts for purchase commitments.[39] In the final analysis, the problem is similar to any other valuation problem, and all factors having a bearing upon the question should be examined. In those cases in which the valuations have been supported by sound evidence that could be followed to a satisfactory conclusion by the reviewing body, the taxpayer has been sustained.[40] In those cases where the valuation is based on arbitrary adjustments by the officers, the taxpayer's position has been reversed.[41]

Factors present at the date of valuation only should be considered, not circumstances affecting the value that arise later.

12. Reproductive Cost

When there is no market for goods in process and for finished goods, the taxpayer's reproductive cost may be used.[42]

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[38] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-4. *Mutual Chemical Co. of America*, 12 B.T.A. 578.

[39] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-4.

[40] *Frederick A. Stearns*, 8 B.T.A. 884 (1927); *California Canneries Co.*, 2 B.T.A. 109 (1925); *True, et al.*, 6 B.T.A. 1042 (1927); *A. P. Mitchell Auto Co.*, 10 B.T.A. 1001 (1928); *Estate of Gustav A. Preuss*, 20 B.T.A. 447 (1930); *Wood & Ewer Co.* v. *Ham* (D.C. Maine 1926), 14 F. 2d 995; 6 AFTR 6314; *Industrial Lumber Company, Inc.* v. *Commissioner* (5 Cir. 1932), 58 F. 2d 123, 11 AFTR 151; *Gunderson Brothers Engineering Corp.*, 16 T.C. 118 (1951); *Leo J. Omelian*, 12 T.C.M. 306 (1953), *Gem Jewelry Co., Inc.* 6 T.C.M. 11 (1947).

[41] *True et al.*, 6 B.T.A. 1042 (1927). *John L. Ashe, Inc.*, 11 T.C.M. 194 (1952) *Max Freudmann et al.*, 10 T.C. 775 (1948).

[42] *Rialto Mining Corp.* (1940), par. 40,369 Prentice-Hall Memorandum B.T.A.

13. Use of Hedges in Inventory Valuation

Hedging as used by cotton and grain dealers.[43] When a dealer enters into spot or cash transactions for cotton or grain for sale some months in the future, to protect against losses that would be incurred if the market declined during those months, the purchaser enters into futures sales contracts for the delivery of equivalent amounts of the same goods a few months in the future. As the spot goods are sold, the futures sales contracts are concurrently closed by futures purchase contracts. These serve as offsetting transactions, closing out the futures sales contracts.

On the other hand, if the amount required for future dealing will call for more goods than can immediately be purchased advantageously, in order to secure protection against a rising market during the intervening months, the dealer enters into futures purchase contracts for the same goods in the amounts necessary to provide the desired protection. As the goods are acquired by spot or cash purchases, the futures contracts are disposed of by futures sales contracts. This eliminates the speculative risk owing to fluctuation in the market price of the goods.

In the case of the dealer in grain or cotton, the customary practice is to inventory at current market. Therefore, since this has the effect of taking unrealized profits and losses into the inventory, it is likewise required that the futures contracts hedging these inventory items be adjusted to present value in the balance sheet, with offsetting income adjustment. This has the effect of offsetting unrealized gain or loss in the inventories in the same manner as would be the case if insurance were carried to cover the speculative risk.

Hedging in the case of cotton textile and other manufacturers.[44] In the case of the cotton textile and other manufacturers, it is the custom to take gain or loss on the hedge into account only when it is closed out. This is done by picking up the gain or loss when the futures purchase contract is closed out by the futures sales contract. If these are truly hedging transactions, and not speculative ones, the gain or loss is ordinary, whereas if the transactions do not represent hedges, they result in capital loss or gain.

In order to establish the transaction as a true hedge, it must represent a purchase or sale for future delivery intended to offset and to protect against price fluctuations of the commodity used in your business. In other words, hedging is a form of price insurance and the basic principle of hedging is the maintenance of a balanced market position. In order to establish your transaction as a true hedge, you must show that at the time you entered into a contract for sale or delivery of a commodity at a future date, you have entered into a contract for the purchase of a similar commodity for future delivery. The distinction between a true hedge and a speculative transaction is important because the losses on the true hedges are deductible in full as ordinary losses, but those on speculative transactions are treated as capital losses, and their deductibility is limited by the provisions of Section 1222 of the 1954 Code, formerly Section 117 of the 1939 Code.

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[43] S.M. 5693, V-2 C.B. 20.

[44] G.C.M. 17322, XV-2 C.B. 151.

The treatment of these hedges by the cotton manufacturer differs from that of the dealer. In the case of the manufacturer, when the inventory is valued at the lower of cost or market, no adjustment is made for the present value of the futures contracts. The reason for the distinction between the textile manufacturer and the cotton or grain dealer is the difference in the goods sold. The dealer handles a large volume of fungible goods, which may be valued in bulk. The textile manufacturer ordinarily earmarks the bales of cotton entering into his product, and can identify them. Therefore, unless the hedges are earmarked as protecting specific bales of spot cotton, it is impossible to ascertain the extent to which gains or losses on open hedges should be reflected in income at the close of the accounting period in order to offset unrealized profits and losses in the inventory. For this reason, the Treasury Department has taken the position that the gains or losses from the hedges should be taken into income or expense by textile manufacturers when the hedges are closed, and not in the manner followed by dealers in cotton or grain.[45] For this reason, no adjustment is made to the market value of the goods for hedges not closed out.

The effect of using LIFO on treatment of hedging transactions. In the case of the hedging transactions of commodity dealers, the excess of purchases over sales represented by closed transactions involving true hedges may be inventoried, and the elective or LIFO method used. This rule also applies to the cases of textile and other manufacturers who engage in similar transactions to protect themselves against fluctuations in the prices of raw materials.

14. Inventories of Dealers in Securities[46]

If you are a dealer in securities, you may inventory your securities at cost, at lower of cost or market, or at market. To qualify as a dealer in securities you must have an established place of business and be regularly engaged in purchasing and selling securities to customers at a profit. If the securities were purchased for resale, you are classed as a dealer; if they were acquired for speculation or investment, you do not so qualify. The Regulations liken the dealer to a merchant. His securities are considered to constitute property purchased for resale to customers in the ordinary course of his trade or business.

The Revenue Act of 1950[47] amended the Internal Revenue Code to require a dealer in municipal securities, who holds short-term municipal bonds for sale to customers, to amortize the bond premium. This is effective for bonds acquired after June 30, 1950. If the dealer's gross income is computed without inventories, or with inventories at cost, the adjusted basis of each bond sold must be reduced by the amortization that is applicable to it.

If the gross income of the dealer is computed with inventories valued at other than cost, the basis of the securities sold must be reduced by the amortizable bond premium.

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[45] Bureau letter dated September 12, 1940.

[46] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-5.

[47] 1954 IRC § 75(a); 1939 IRC § 22(o); Reg. 118 § 39.22(o).

15. Inventories of Farmers[48]

Farmers who wish to change from their usual method of reporting on the cash receipts and disbursements basis to an inventory basis may choose one of two methods of doing so. The method chosen will be binding in future years, unless permission to change is authorized by the Commissioner.

In[49] following the first of these methods, the opening and closing inventories must be used for the year of the change, and there shall be included in the opening inventory all farm products purchased or raised that were on hand at the inventory date. The taxpayer is required to submit with his tax return for the current year an adjustment sheet for the preceding year on which the income for that year is determined by use of the inventory method. If an additional tax would be due on this basis for the preceding year, it must be paid.

The second method requires no adjustment sheet but the income is computed without taking into consideration the inventory at the beginning of the year.[50] If livestock, grain, or other property on hand at the beginning of the taxable year has been purchased and the cost was not charged to expense, only the difference between the cost and selling price of the goods should be reported as income when they are sold.[51] On the other hand, if the entire amount was charged to expense when the purchase was made, the entire amount must be reported as income for the year in which sold.

Farm price method. The farm price method permits the valuation of livestock and farm inventories on the basis of market price, less cost of disposition. All crops must be taken into the inventory, but if the taxpayer wishes to do so, the livestock may be valued by using the unit livestock price method.[52] When this method is followed the different classes of animals in the inventory are valued at a standard unit price for each animal within a class. In using this method, all livestock purchased must be included in the inventory with the exception of the animals acquired for breeding, dairy, or draft purposes. At the election of the taxpayer, these may either be included in the inventory, or be treated as assets subject to the depreciation allowance after maturity.

The livestock purchased must be taken into the inventory at cost. When animals are not mature at the time of purchase, the cost should be increased by the estimated cost of raising the animal year by year, until it is mature. This increase is to be based on established unit prices. No increase is to be made, however, for the year of the purchase of the animal, if acquired during the last six months.

16. Records to Be Kept

Inventories should be recorded in a legible manner, properly computed and summarized. The inventory sheets are essential records of the taxpayer, vital in the determination of taxable net income.[53] They should be carefully preserved for the inspection of the government.

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[48] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-6.

[49] A. J. *McDaniel,* 19 T.C. 474 (1952).

[50] 1954 IRC § 471; 1939 IRC § 22(c); Reg. 118 § 39.22(c)-6.

[51] *Ibid.*

[52] *Ibid.*

If book or perpetual inventories are kept, they should be verified and adjusted by physical count at reasonable periods.[54]

17. Correcting Errors in the Opening Inventory

If corrections of errors in method are made in the closing inventory, the opening inventory must also be adjusted.[55] The courts have sustained the Commissioner's position that where the taxpayer undertakes to use an opening inventory higher than the closing inventory of the preceding year, thus gaining a tax advantage, the Commissioner may invoke the doctrine of estoppel to prevent him.[56] If, therefore, in a year barred by the statute of limitations, a taxpayer has taken a position that a closing inventory is a certain amount, an undertaking by him to allege that the opening inventory of the following year is higher will probably fail.[57] The doctrine of estoppel no doubt will be invoked on the grounds that the taxpayer, who was in possession of the facts concerning his inventory, made a representation of these facts to the Government, which relied thereon to its detriment. The taxpayer will therefore be estopped from denying the correctness of its previous representations, because to permit him to do so would cause the Government to lose tax justly due.

When, however, the correct opening inventory was determined to be lower than the inventory used in closing a preceding year, one barred by the statute of limitations, the Government will succeed when it undertakes to reduce this opening inventory.[58]

18. Adjustments Because of Change in Inventory Methods

Although inventories may be required in the case of a particular taxpayer because they constitute material income producing factors, he may fail to take them properly into account in computing his income. Under such circumstances, when the correction is made, the year of change over presents certain troublesome problems. If an opening inventory is used for the first time in the year of the change a certain amount of income will escape taxation, whereas if no opening inventory is used but the closing inventory is taken into account, the income will be pyramided and higher tax rates may apply. The 1954 Internal Revenue Code permits that certain adjustments be made in the transitional year to alleviate this situation provided that the taxpayer is changing from a method that was in use the two years preceding the change. The applicable section of this law applies not only to transitional adjustments growing out of the change of inventory treatment but likewise those resulting from the change in treatment of accounts receivables and other accruable items. If the increase of income because of the change in treatment of inventories is in excess of $3,000, the tax applicable thereto may not exceed the amount that would result if this income adjustment should be spread equally over three years, the current year and the two preceding years.[59]

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[53] *Bryan, L. M.*, 44 B.T.A. 141 (1941).

[54] *College Point Boat Corp.*, 1 B.T.A. 534 (1924).

[55] *Eureka Fire Bricks Works*, 5 T.C.M. 1106 (1946).

[56] *Swift Manufacturing Company* v. *U.S.*, 12 F. Supp. 453 (1935), 16 AFTR 949.

[57] *Ibid.*

[58] *Commissioner* v. *Gooch Milling & Elevator Co.*, 320 U.S. 418, 64 Sup. Ct. 184 (1943), 31 AFTR 764.

19. Valuation of Inventories Received in Certain Nontaxable Reorganizations or Liquidations

If a corporation receives inventories from another corporation in a nontaxable reorganization, including a statutory merger or consolidation, or in the liquidation of a wholly-owned subsidiary, the transferor corporation's method of valuing this inventory must be continued by the acquiring corporation. This rule does not apply upon the liquidation of a subsidiary corporation when 80 per cent of its stock was acquired by purchase within a period of not more than 12 months, and the liquidation occurred pursuant to a plan adopted on or after June 22, 1954, and not more than two years after the acquisition of the subsidiary's stock.

If the inventories of several corporations are taken over in this manner, and the valuation methods used by the transferors are different, the method of taking inventory shall be governed by regulations prescribed by the Secretary or his delegate.[60]

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[59] 1954 IRC § 481(b).

[60] 1954 IRC §§ 381(a); 381(c)(5).

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18

Foreign Sales

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This chapter is concerned with the United States income tax consequences of sales effected in foreign countries.

1. Points to Consider

An examination of such consequences should commence with a consideration of the question:

	Section
Which classes of taxpayers are concerned with the tax consequences of foreign sales	2
Here a distinction should be made between:	
Non-resident aliens and foreign entities selling abroad to U.S. purchasers; and	2(a)
American citizens, resident aliens, and American corporations, who or which:	2(b)
Sell abroad directly, without the interposition of a separate legal entity; or	
Channel their foreign sales operations through separate legal entities; or	
Sell to or from a U.S. possession in such a manner as to qualify for special tax treatment; or	
Sell to or from Western Hemisphere countries in such a manner as to qualify for the special treatment accorded to Western Hemisphere Trade Corporations; or	
Sell to or from Formosa or Hong Kong through so-called China Trade Act Corporations.	

For all these taxpayers it is of importance to determine:

Whether their income from sales is derived from foreign sources	3
Under this topic there will be discussed:	
Sales of real property	3(a)
Sales of tangible personal property	3(b)
The title passage theory	3(c)
Sales of intangible personal property	3(d)

Within the framework of the tax law as set forth in the preceding sections, there must be considered:

Section
The relative advantages and disadvantages of various types of selling operations 4
They must be analysed from the viewpoint of:
  Non-resident aliens and foreign entities selling abroad to U.S. purchasers .... 4(a)
  Domestic taxpayers selling abroad directly .... 4(b)
  Domestic taxpayers selling abroad through foreign subsidiaries .... 4(c)
  Domestic taxpayers engaging in foreign operations which qualify for special tax treatment .... 4(d)

The discussion will center primarily around sales of merchandise. Tax consequences of sales of intangible personal property will be adverted to only incidentally.[1]

2. Types of Taxpayers

The first question facing foreign individuals or entities is whether their income from foreign sales is subject to United States income taxation. Domestic taxpayers are as a rule subject to United States income tax on their entire income, regardless of whether it be derived from foreign or domestic sources. Depending on the type of operation engaged in, however, the income from foreign sales effected on behalf of domestic taxpayers may escape immediate United States income taxation. Even if the income is taxable in the United States, the classification of the sale as a foreign one may influence the size of certain tax credits and deductions.

a. Non-resident aliens and foreign entities. Non-resident alien individuals and foreign entities[2] are never subject to United States income taxation on income derived from sources outside the United States.[3] In the case of sales, therefore, United States income tax consequences can result to such foreign taxpayers only if the profits therefrom are deemed to be income from United States sources. As a rule such profits are taxed only to foreign taxpayers engaged in trade or business within this country.[4]

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[1] The question whether income constitutes profits from sales or whether it constitutes another type of compensation is also outside the scope of this discussion; *see* e.g. *Piedras Negras Broadcasting Co.* v. *Commissioner* (5 Cir. 1942), 127 F. 2d 260, 29 AFTR 243; *British Timken Ltd.*, 12 T.C. 880 (1949) (profits from sales or income from services).

[2] The source of a foreign corporation's income is determinative not only of the U.S. income tax liability of the corporation itself. The classification of the income into foreign or domestic income also affects the tax liabilities of the corporation's stockholders or creditors in a number of instances. Thus, foreign stockholders or creditors of a foreign corporation are subject to U.S. tax on dividends or interest paid by the corporation only if these items constitute income from U.S. sources within the meaning of the statute. Under the statutory definitions (unless a treaty provides otherwise), dividends of a foreign corporation are treated as partly from U.S. sources if 50% or more of the corporation's gross income for a certain period was derived from such sources; *cf.* 1954 IRC § 861(a)(2)(B); 1939 IRC § 119(a)(2)(B). Interest paid by a resident foreign corporation will constitute domestic income if 20% or more of corporate gross income for a certain period was from U.S. sources; *cf.* 1954 IRC § 861(a)(1)(B); 1939 IRC § 119(a)(1)(B). Moreover, a corporate stockholder may claim as a deduction a proportionate part of the dividends received from a resident foreign corporation which derived 50% or more of its income from U.S. sources; *cf.* 1954 IRC § 245; 1939 IRC § 26(b)(3) (under prior law the allowance for dividends received was expressed in terms of a credit).

[3] *Cf.* 1954 IRC §§ 871, 872; 1939 IRC § 211 (individuals); 1954 IRC §§ 881, 882; 1939 IRC § 231 (corporations).

Under the income tax treaties entered into with various foreign states,[5] even income from sales that would normally be subject to taxation is exempted from tax in certain cases.[6] Although the treaties differ in detail, they generally provide that "enterprises" of foreign treaty countries, including individual alien residents, corporations, and other entities of such countries, not having a "permanent establishment" [7] in the United States, shall not be subject to United States income taxation on commercial and industrial profits derived by them from sources within the United States.[8]

As a rule a branch, factory, warehouse, or other fixed place of business constitutes a permanent establishment. An office maintained in the United States solely for the purpose of purchasing goods, however, does not have this effect. A treaty-country enterprise is deemed to have a permanent establishment in the United States if it sells through an agent or employee in this country who has power to conclude contracts or who has a stock of merchandise from which he regularly fills orders on behalf of the enterprise.

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[4] *See* Code sections cited footnote 3, above. For discussion of the concept of being "engaged in trade or business in the United States," see Franz Martin Joseph, "Organizing International Businesses," *Taxes—The Tax Magazine*, September 1952, Vol. 30, at pages 729, 730.

[5] Treaties for the avoidance of double taxation on income are in effect with: Australia, effective 1-1-53; Belgium, effective 1-1-53; Canada, effective 1-1-41, supplemental convention effective 1-1-51; Denmark, effective 1-1-48 with respect to U.S. taxes, 4-1-48 with respect to Danish taxes; Finland, effective 1-1-52; France, effective 1-1-45, supplemental convention effective 1-1-50; Greece, effective 1-1-53; Ireland, effective 1-1-51; Japan, effective 1-1-55; Netherlands, effective 1-1-47; New Zealand, effective 1-1-51; Norway, effective 1-1-51; Sweden, effective 1-1-40; Switzerland, effective 1-1-51; Union of South Africa, effective 7-1-46; United Kingdom, effective 1-1-45 with respect to U.S. taxes, 4-6-45 with respect to U.K. taxes; Western Germany, effective 1-1-54.

A treaty with Italy was signed 3-30-55. The Senate consented to ratification 7-29-55.

Treaty discussions are in various stages of progress with Argentina, Austria, Brazil, Colombia, Cuba, Honduras, Israel, Luxembourg, Mexico, Paraguay, Philippines, Uruguay, Venezuela.

[6] In addition to the special treatment of industrial or commercial profits discussed below, a few treaties exempt gains from the sale of securities or other capital assets from U.S. tax, if received by treaty-country residents or corporations not engaged in business in the U.S. or not having a permanent establishment therein; *cf.* Canada, Art. VIII; France, Art. II; United Kingdom, Art. XV. Non-resident alien individuals not engaged in business in the U.S. are, in the absence of treaties, taxable on capital gains from U.S. sources, under certain conditions; *cf.* 1954 IRC § 871(a)(2); 1939 IRC § 211(a)(1)(B).

[7] For definitions of "permanent establishment," *see:* Australia, Art. II (1) (o); Belgium, Art. II (1) (f); Canada, Protocol, Art. III (f), T.D. 5206, § 7.22(a); Denmark, Art. II (c), T.D. 5777, § 7.953(a); Finland, Art. II (c); France, Protocol, Art. III (a), T.D. 5499, § 7.413(a); Germany, Art. II(1) (c); Greece, Art. II (1) (i); Ireland, Art. II (1) (1); Italy, Art. II (1) (c); Japan, Art. II (1) (c); Netherlands, Art. I (1) (i), T.D. 5778, § 7.853(a); New Zealand, Art. II (1) (o); Norway, Art. II (1) (c); Sweden, Protocol, Art. 1 (a), T.D. 4975, § 25,2(a); Switzerland, Art. II (1) (c); Union of South Africa, Art. II (d); United Kingdom, Art. II (1) (l), T.D. 5569, § 7.515(a).

[8] If such treaty-country enterprises maintain a permanent establishment in the United States, they are subject to tax on profits from U.S. sources. In that event all such profits will be allocated to the permanent establishment even though the parent enterprise may have conducted certain transactions with U.S. customers directly, without using the permanent establishment. *Cf.* Australia, Art. III; Belgium, Art. III; Canada, Art. I; Denmark, Art. III; Finland, Art. III; France, Art. III; Germany, Art. III; Greece,, Art. III; Ireland, Art. III; Italy, Art. III; Japan, Art. III; Netherlands, Art. III; New Zealand, Art. III; Norway, Art. III; Sweden, Art. II; Switzerland, Art. III; Union of South Africa, Art. V; United Kingdom, Art. III.

On the other hand, sales through independent commission agents or brokers, acting in the ordinary course of their business, do not give rise to a permanent establishment in the United States. A subsidiary corporation is considered to be a permanent establishment of its foreign parent only if it meets the conditions under which an agent would be so treated.

b. U.S. citizens, resident aliens and domestic corporations. To domestic taxpayers, including U.S. citizens, resident aliens, and domestic corporations, the question whether profits from foreign sales constitute income from foreign or domestic sources is important in a number of ways.

General rule: Domestic taxpayers selling abroad directly or through agents or branch establishments are generally taxable on the income from such sales, regardless of its characterization as income from foreign or United States sources.[9] The source of the income assumes importance, however, for the purpose of establishing the relative proportions of foreign income to over-all income.

Such apportionment becomes significant in the computation of the Code credit for income or similar taxes paid or accrued to foreign countries or to United States possessions.[10] This credit is available to U.S. citizens, domestic corporations, and to resident aliens whose country of nationality allows a similar credit against its tax to U.S. citizens residing in its territory.[11] The credit allowable for taxes paid or accrued to any particular country is limited to the proportion which taxable income from sources within such country bears to taxable income from all sources.[12] For purposes of this "per country" limitation, therefore, it must be determined whether income from sales was derived from a particular country or possession.[13]

In a number of other situations the proportion of foreign income to total taxable income is the measuring rod under the Internal Revenue Code.[14] Thus, interest and dividends received from domestic corporations and certain other domestic taxpayers, are, for income tax purposes, treated as income from foreign sources if less than 20 per cent of the payer's gross income for a stated period was derived from sources within the United States.[15] Conversely, dividends received from foreign corporations deriving 50 per cent or more of their gross income from U.S.

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[9] Exceptional treatment accorded to certain types of activities, such as Western Hemisphere or U.S. possession operations, is discussed in a subsequent part of this section of the text.

[10] *Cf.* 1954 IRC §§ 901-905; 1939 IRC § 131.

[11] 1954 IRC § 901(b); 1939 IRC § 131(a); Reg. 118, § 39.131(a)-1, 2. A domestic corporation owning at least 10% of the voting stock of a foreign corporation may claim a credit for foreign taxes paid by the foreign corporation, in the proportion which the dividends received from that corporation bear to its accumulated profits, and a further proportionate credit for taxes paid by a 50%-owned foreign subsidiary of such foreign corporation; *cf.* 1954 IRC § 902(a), (b), (c); 1939 IRC § 131(f); Reg. 118, § 39.131(f); *see* 1954 IRC § 902(d) for special treatment of distributions made by certain wholly owned foreign subsidiaries of domestic corporations.

[12] 1954 IRC § 904(a); 1939 IRC § 131(b)(1). The 1954 Revenue Code has eliminated the additional "overall" limitation contained in the 1939 Code; *cf.* 1939 IRC § 131(b)(2).

[13] For purposes of the tax credit computation a high percentage of foreign income would be advantageous.

[14] *E.g.*, in connection with the ascertainment of taxable (net) income from U.S. or foreign sources; *cf.* 1954 IRC §§ 861(b), 862(b); 1939 IRC § 119(b),(d).

[15] 1954 IRC § 861(a)(1)(B); 1939 IRC § 119(a)(1)(B) (interest from resident aliens, resident foreign corporations and domestic corporations); 1954 IRC § 861(a)(2)(A); 1939 IRC § 119(a)(2)(A) (dividends from a domestic corporation, other than one entitled to the benefits of IRC § 931, formerly § 251).

sources, are deemed to be United States income.[16] Foreign corporate dividends constitute domestic income only in the ratio which the gross income derived by the corporation from U.S. sources bears to its total gross income.[17] In all such cases it must be determined what part of the sales income arose in the United States.[18]

Special situations: Depending upon the entity and operation involved, a sales transaction may either escape U.S. income taxation altogether, or enjoy special tax treatment, if the profits from the sale are derived from certain sources outside the continental United States. The following types of situations are involved:

1. Domestic taxpayers in many cases have their foreign sales operations carried on by separate foreign legal entities. If the income derived by such foreign entities from sales constitutes income from foreign sources, it will not be subject to U.S. income taxation in the hands of the foreign entity. The operations of such foreign entities may consist of sales of merchandise located abroad, to U.S. or to foreign purchasers, or of sales to foreign purchasers[19] of merchandise located in this country.

2. Selling operations in other countries in the Western Hemisphere[20] may be conducted through domestic corporations which qualify as "Western Hemisphere Trade Corporations" within the meaning of the statute.[21] In order to qualify for this status, a domestic corporation must do all of its business in the Western Hemisphere,[22] derive 95 per cent or more of its gross income for a specified period from sources without the United States, and realize 90 per cent or more of its gross income during that period from the active conduct of a trade or business.[23] Corporations that fulfill the foregoing conditions are entitled to a special deduction against taxable income. At the present time, the said deduction amounts to approximately 27 per cent of the taxable income.[24]

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[16] 1954 IRC § 861(a)(2)(B); 1939 IRC § 119(a)(2)(B).

[17] Footnote 16, above.

[18] Under a number of tax treaties dividends and interest paid by treaty-country corporations to non-resident alien or foreign corporate recipients are tax-exempt, so that the source of the payor's income does not affect such recipients; *see e.g.*, Canada, Protocol Art. XII.

[19] In some situations foreign subsidiaries of domestic taxpayers also sell American merchandise to American purchasers.

[20] *I.e.* North, Central, or South America, or the West Indies, including U.S. possessions in that area; *cf.* I.T. 4067, 1951-2 C.B. 55 (Virgin Islands); *see also* Rev. Rul. 55-105, 1955-9 I.R.B. 9; I.T. 3990, 1950-1 C.B. 57 (Bermuda does not qualify as a country in the Western Hemisphere).

[21] *Cf.* 1954 IRC § 921; 1939 IRC § 109. With respect to Western Hemisphere Trade Corporations, the Revenue Code of 1954 made only minor changes. It clarified one of the concepts (*see* footnote 22, below), and changed the tax benefit from a credit to a deduction.

[22] The Revenue Code of 1954 spells out that a domestic corporation is not to be treated as not doing all its business in the Western Hemisphere, by reason of incidental purchases elsewhere. However, this clarification is not to be applied retroactively to taxable years beginning prior to January 1, 1954; *cf.* 1954 IRC § 921.

[23] *See* Code sections cited footnote 21, above. It might also be noted that the House version of the 1954 Revenue Code furthermore contained a section granting a special tax credit with respect to certain types of business income received by domestic corporations from sources in any foreign country; H.R. 8300, § 923. The Code as finally adopted, however, omitted this provision, the matter being left open for further study; *see* House Conference Committee Report on Amendment No. 207.

[24] It is computed by multiplying taxable income by a fraction the numerator of which is 14% and the denominator of which is the sum of the prevailing corporate normal and surtax rates; 1954 IRC § 922. Under the 1954 Code, therefore, that fraction is 14/52 for taxable years

3. Corporations organized under the China Trade Act of 1922 are also granted a special deduction against taxable income.[25] The amount of the deduction is equal to the proportion of taxable income derived by such corporation from sources within Hong Kong or Formosa, which the par value of its stock owned by residents of Formosa, Hong Kong, the United States or its possessions, or by United States citizens, bears to the par value of the total outstanding corporate stock.[26] The allowance of the deduction is subject to the fulfillment of certain conditions.[27]

4. U.S. citizens or domestic corporations deriving 80% or more of their gross income for a designated period from sources within a possession of the United States and 50 per cent or more of their gross income from the active conduct of a trade or business within a U.S. possession, are taxed only on their income from sources within the United States.[28] Assuming that the activities consist of selling, the question arises whether the required percentage of sales income can, within the meaning of the statute, be considered as having been derived from possession sources.[29] It should be noted that amounts actually received in this country are includable in the taxable income, regardless of whether the income was technically derived from foreign sources.[30] Similarly, citizens of U.S. possessions who are not residents of the United States are subject to tax only on income from sources within the United States.[31]

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beginning prior to April 1, 1955, and 14/47 for taxable years beginning after that date; 1954 IRC § 11. The Revenue Code of 1939 expressed the tax benefit in terms of a credit but did not in substance differ from the provisions of the present law; *cf.* 1939 IRC §§ 26(i), 13(a)(2)(C), 15(a)(3).

[25] *Cf.* 1954 IRC §§ 941-943; 1939 IRC §§ 261-3.

[26] 1954 IRC § 941(a); 1939 IRC § 262(a). The only substantive changes made by the 1954 Code were in the definition of the geographic source of the income (confining it to sources within Hong Kong or Formosa, instead of "China" as under prior law), and the definition of the foreign stockholders (residents of Formosa or Hong Kong only, instead of citizens or residents of China).

[27] A certification by the Secretary of Commerce to the Secretary of the Treasury regarding the amounts and proportions of special dividends distributed by the corporation during the taxable year to those of its stockholders who were resident in Formosa, Hong Kong, the United States or a U.S. possession, or who were U.S. citizens; 1954 IRC § 941(b); 1939 IRC § 262(b).

[28] 1954 IRC § 931; 1939 IRC § 251. The term "possession" does not include the Virgin Islands, or, with respect to U.S. citizens (not, however, domestic corporations), Puerto Rico; *cf.* 1954 IRC § 931(c); 1939 IRC § 251(d). Nor does it include occupied territories, such as the Marshall Islands (I.T. 4080, 1952-1 C.B. 139) or Okinawa (Rev. Rul. 199, 1953 I.R.B. No. 20, p. 17). It includes the Panama Canal Zone, American Samoa, Wake, and Midway; Reg. 118, § 39.251(d)-1.

[29] The statute refers to income from sources within "a possession of the United States." It is not clear whether 80% of the income must be derived from one possession, or whether it may be received from a number of possessions.

[30] 1954 IRC § 931(b); 1939 IRC § 251(b). The taxability of income received here, however, does not affect the source of that or other income for purposes of the foregoing sections. If, under the applicable rule, the required percentage of income is derived from possession sources and from the active conduct of a business in a possession, all income from foreign sources which was not received in the U.S. is exempt from tax; *cf.* Reg. 118, § 39.251(b)-1.

[31] Provided they are not citizens of the U.S.; 1954 IRC § 932; 1939 IRC § 252. They are taxed in the same manner as non-resident aliens; Reg. 118, § 39.252-1. The section does not apply to citizens of Puerto Rico. On the other hand, residents of Puerto Rico (whether U.S. or Puerto Rican citizens or aliens) are exempt from tax on income from Puerto Rican sources; 1954 IRC § 933; 1939 IRC § 116(1). Such residents of Puerto Rico are, except with respect to Puerto Rican income, subject to U.S. tax on income from all sources; *cf.* 1954 IRC § 876; 1939 IRC § 220; Reg. 118, § 39.220-1.

3. Sales Income from Foreign Sources

a. Sales of real property. Income from the sale or exchange of real property constitutes (1) income from foreign sources if the real property is located abroad, and (2) income from U.S. sources if the property is located in the United States.[32] Few problems present themselves under this rule. The question may arise whether certain assets are real or personal property.

In a case involving the sale of Texas oil and gas leases, the foreign seller claimed that the profits from the sale constituted income resulting from the sale of personal property which, since the transfer took place abroad, should be treated as income from foreign sources. The Court held that the law of the situs of the property governed. Since under Texas law leases are deemed to be real property, the Court held the income to be derived from the sale of real property located in the United States.[33]

In cases involving the characterization of rights connected with foreign real property, the law of the foreign situs will presumably be applied, as was done in estate tax cases.[34]

b. Sales of tangible personal property. The Internal Revenue Code makes a distinction between the so-called producer-seller and the so-called purchaser-seller.

The producer-seller: Income from the sale of tangible personal property produced, manufactured, or otherwise processed or treated by the taxpayer, in whole or in part, in the United States and sold abroad, is deemed to be derived partly from sources within and partly from sources without the United States. The same rule applies to tangible personal property produced or otherwise processed by the taxpayer abroad and sold within the United States.[35] A taxpayer who produces in the United States and sells abroad can therefore never obtain income wholly from foreign sources.[36] On the other hand, a foreign producer who sells to U.S. purchasers may obtain income wholly from foreign sources if the sale is not made within the United States.[37] If under the foregoing principles income from the sale is deemed to be derived partly from U.S. and partly from foreign sources, an allocation must be made in accordance with rules laid down in the Treasury Regulations. Briefly, the allocation principles are as follows:

1. If, on the basis of arm's-length sales to independent purchasers, the producer-seller can establish a separate and independent production price, and if the

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[32] 1954 IRC § 861(a)(5); 1939 IRC § 119(a)(5); Reg. 118, § 39.119(a)-5.

[33] *Texas-Canadian Oil Co., Ltd.*, 44 B.T.A. 913 (1941).

[34] *Cf. Fair* v. *Commissioner* (3 Cir. 1937), 91 F. 2d 218, 19 AFTR 1097 (Cuban mortgage); Estate of Margaret Thaw Carnegie de Perigny, 9 T.C. 782 (1947) (long-term leasehold on real property in Kenya Colony, British East Africa); *Laird* v. *U.S.* (D.C., W.D. Wisc. 1953), 115 F. Supp. 931 (Canadian timber leases).

[35] 1954 IRC §§ 863(b), 864; 1939 IRC § 119(e), (f); Reg. 118, § 39.119(e)-1.

[36] Income derived by a U.S. producer of farm products, timber, oil, minerals and other natural resources, from the sale of such products, is generally treated as derived entirely from U.S. sources, regardless of the place of sale, unless an equitable allocation method can be shown; Reg. 118, 39-119(a)-7.

[37] *Cf.* A.R.M. 133, 4 C.B. 114; I.T. 2869, XIV-1 C.B. 113.

selling department is located in a different country from the factory or production establishment, the regular production price is allocated to the production department and the selling price to the selling department.[38]

2. If no such independent production price can be established, the net income from sales transactions is first computed. One-half of the net income is then apportioned in accordance with the value of the taxpayer's property within the United States and the property within the foreign country. The other half is apportioned in accordance with the taxpayer's gross sales within the United States and those within the foreign country. It should be noted that for purposes of this allocation, sales within the United States are not determined in accordance with the ordinary rules of title passage, as explained below. Instead they include all sales which were principally secured, negotiated or effected by employees, agents, offices or branches of the taxpayer residing or located in the United States.[39] The same rules apply with respect to property produced in whole or in part in a U.S. possession and sold within the United States and vice versa, except that the second half is allocated in accordance with total business done in the U.S. and in a possession.[40]
3. In lieu of the allocation formula the taxpayer's books of account may be used for purposes of allocation if they are kept in good faith and if they reflect the income derived from U.S. sources more clearly than the allocation formula would.[41]

Purchaser-seller: Income derived from the purchase by the taxpayer of tangible personal property in, and from its sale outside of the United States, is derived entirely from sources within the country of sale.[42] This rule includes U.S. possessions. Personal property purchased by the taxpayer abroad and sold within the United States constitutes income wholly from U.S. sources.[43]

Property purchased in a U.S. possession and sold within the United States, however, is treated as derived partly from sources within and partly from sources without the United States, allocation being made in the proportion of business done in the U.S. to business done both in the United States and in the U.S. possession.[44]

In all cases of sales of tangible personal property, therefore, particularly those of the purchase-sale type, the source of the income depends upon the place of sale.

c. The place of sale of tangible personal property. The courts have consistently held that the place of sale is the location where the final event occurs that causes title to the goods to pass.[45] In determining the place of title passage, the intention of the parties governs. In the absence of any expressed intention, the law of sales establishes certain presumptions. Normally, in the case of ascertained goods, title is deemed to pass upon delivery to the carrier for shipment to the purchaser.[46]

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[38] *Cf.* Reg. 118, § 39.119(e)-1, Case A1.

[39] *Cf.* Reg. 118, § 29.119(e)-1, Case A2.

[40] *Cf.* Reg. 118, § 39.119(e)-1, Cases B1, B2.

[41] Reg. 118, § 39.119(e)-1, Cases A3, B3.

[42] 1954 IRC § 862(a)(6); 1939 IRC § 119(e); *see also* I.T. 2869, XIV-1 C.B. 113; I.T. 2002, III-1 C.B. 226.

[43] 1954 IRC § 861(a)(6); IRC § 119(e); Reg. 118, § 39.119(a)-6.

[44] *Cf.* Reg. 118, § 39.119(e)-1(c).

[45] *Commissioner v. East Coast Oil Co. S.A.* (5 Cir. 1936), 85 F. 2d 322, 18 AFTR 446, affirming 31 B.T.A. 558 (1934), cert. den. 299 U.S. 608 (1936); *Ronrico Corp.*, 44 B.T.A. 1130 (1941), acq. 1944 C.B. 24; *Elston Co., Ltd.*, 42 B.T.A. (1940); *Hazelton Corp.*, 36 B.T.A. 908 (1937), app. dism. (9 Cir. 1939) 100 F. 2d 1012; *Anglo-Mexican Petroleum Co., Ltd.*, par. 37,353 *Prentice-Hall Memorandum* B.T.A. (1937); but *cf. U.S.* v. *Balanovsky* (D.C., S.D.N.Y., March 11, 1955), 1954-5 *Prentice-Hall Federal Tax Service*, par. 72,609, where the court severely criticized the title passage theory.

The position of the Government on this question has shifted repeatedly. For a time it followed the title passage theory.[47] Thereafter, for a period of 17 years, it held the place of negotiation and execution of the sales contract to be the place of sale.[48] In 1947, however, the Government re-adopted the place of title passage as the controlling factor and has since maintained this position. G.C.M. 25131[49] states the general rule to be that "for the purpose of determining the source of income attributable to the sale of personal property, a sale is consummated at the place where the seller surrenders his right, title, and interest to the buyer." The retention by the seller of bare legal title for security purposes, however, will not preclude the passage of beneficial title to the buyer. The ruling, therefore, provides that "in cases in which the bare legal title is retained by the seller, the sale will be deemed to have occurred at the time and place of the passage to the buyer of the beneficial ownership and the risk of loss."

The ruling warns that the general principles of title passage will not be applied "in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance." In such a case, all factors of the transaction, such as the place of contract negotiations and execution, the location of the property, and the place of payment will be considered; and the sale will be treated as having been consummated at the place where the substance of the transaction occurred.

In the ordinary f.o.b. sale, the contract price includes all charges incident to the delivery of the merchandise "free on board" to a designated point. In c.i.f. contracts the agreed price covers the cost of the goods, insurance, and freight to the point of destination. In both types of contracts, beneficial ownership and title are normally deemed to pass to the buyer at the point of delivery to the carrier.

In *Commissioner* v. *East Coast Oil Co. S.A.*,[50] Mexican oil was sold to a U.S. purchaser. Some of the contracts stipulated a price c.i.f. wharf tanks at Galveston, Texas, and Algiers, Louisiana. Others provided for delivery of the oil at a wharf at Tampico, Mexico, to tankers owned by the buyer. The latter contracts were held to be ordinary f.o.b. contracts. The Court stated that, under either form of contract, title passed to the purchaser on delivery of the goods to the carrier and the surrender to the buyer of the bill of lading and other shipping documents. The place where the order was accepted, or where the sales negotiations were conducted or the contract signed, were held not to affect the rules of title passage.[51] Similarly, no significance was attached to the agreed place and manner of payment,[52] or the location of the main center for purchasing and selling activities.[53] The fact that the merchandise is subject to inspection at the place of ultimate destination does not negate the transfer of title at the point of delivery to the carrier.[54]

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[46] *Cf.* Uniform Sales Act, §§ 18, 19.

[47] *See e.g.*, O.D. 651, 3 C.B. 265; O.D. 1100, 5 C.B. 118; I.T. 1569, II-1 C.B. 126.

[48] G.C.M. 8594, IX-2 C.B. 354.

[49] 1947-2 C.B. 85.

[50] (5 Cir. 1936) 85 F. 2d 322, 18 AFTR 446; affirming 31 B.T.A. 558 (1934), cert. den. 299 U.S. 608 (1936), acq. 1947-2 C.B. 2.

[51] *Commissioner* v. *East Coast Oil Co. S.A.*, footnote 50, above; *Exolon Co.*, 45 B.T.A. 844 (1941); *Briskey Co.*, 29 B.T.A. 987 (1934), affirmed (3 Cir. 1935) 78 F. 2d 816, 16 AFTR 490; *see also Askania Werke A.G.* v. *Helvering* (D.C. Cir. 1938), 96 F. 2d 717, 21 AFTR 179.

[52] *Ronrico Corp.*, *Anglo-Mexican Petroleum Co., Ltd.*, footnote 45, above.

As previously mentioned, the retention of legal title by the seller for security purposes does not vary the rule. In the case of *Ronrico Corporation*,[55] a Puerto Rican corporation, engaged in the production of rum, had an exclusive sales agreement with a U.S. distributor. Prices were "c.i.f. Atlantic Seaboard and Gulf ports." The foreign corporation delivered the merchandise at Puerto Rican ports to vessels designated by the purchaser. However, it took the bills of lading to its own order and procured insurance on the merchandise in its own name. Nonnegotiable bills of lading were forwarded to the purchaser at the time of shipment. Payment was made by sight draft against bills of lading and insurance policies.

These variations of the ordinary c.i.f. contract were held not to affect the passage of title at the place of delivery to the carrier in Puerto Rico. The Court stated that "it is recognized that where this method of dealing is followed only for the purpose of giving some security to the seller, it does not prevent passage of beneficial ownership and risk of the goods to the buyer at the point of shipment."

The letters, "f.o.b." or "c.i.f," however, are not conclusive. The courts look to the true intention of the parties in order to ascertain where the beneficial ownership and risk of loss pass. In one case, involving an excise tax liability, a foreign seller had contracted for the sale of matches "f.o.b. European ports," but retained the bills of lading to its own order and listed itself as the owner on entry papers and warehousing records in this country. The appellate court remanded the case to the trial court for determination whether the parties intended title to pass in Europe or in the United States.[56]

In the case of contracts for the sale of unascertained goods, title passes generally at the time when specific goods are appropriated to the contract in accordance with its terms.[57] In *Briskey Co.*,[58] for example, the taxpayer's home office in the United States regularly received orders for goat skins, which it cabled to its branch in India. The branch then purchased skins and shipped them sometimes directly to customers in the United States, but in other cases to the home office for delivery to customers. Each shipment was earmarked for a particular purchaser. On these facts, title was held to have passed in India where the goods were acquired and applied to the orders.

In another situation the American broker of a Philippine lumber firm procured orders in the United States, which it forwarded to the lumber company. The company consigned the lumber to the broker in the United States who paid freight and insurance thereon from the Philippines to the point of delivery to the customer in the United States, and collected the price, which it then credited to the principal's account. The sales were held to have been made in the Philippines.[59]

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[53] Cf. Guy Livingston, par. 45,314, Prentice-Hall Memorandum T.C. (1945); *Dorn & Co.*, 12 B.T.A. 1102 (1928); *Anglo-Mexican Petroleum Co., Ltd.*, footnote 45, above.

[54] *Commissioner* v. *East Coast Oil Co. S.A.*, footnote 50, above.

[55] Footnote 45, above.

[56] *Amtorg Trading Corp.* v. *Higgins* (2 Cir. 1945), 150 F. 2d 536, 34 AFTR 55; *see also* G.C.M. 2467, VII-2 C.B. 188 (sales c.i.f. foreign port, insurance by buyer. Held: Parties intended to pass title at U.S. port).

[57] Williston, Samuel, *The Law Governing Sales of Goods*, Revised Edition, Vol. 2, § 258. New York: Baker, Voorhis & Co., Inc. (1948).

[58] Footnote 51, above.

d. Sales of intangible personal property. The recognized rule appears to be that title to securities generally passes at the time and place of delivery to the buyer or his agent of the bearer certificates or endorsed registered certificates.[60]

In *Hazleton Corporation,*[61] stockholders of a domestic corporation planned to sell their stock to another domestic corporation engaged in the same business. They formed a Panama corporation having its principal place of business in Canada and transferred to it the stock of the American corporation in exchange for the stock of the Panama corporation. The latter corporation then sold and transferred the American stock to the ultimate American purchaser in Canada. Negotiations had been carried on and the terms substantially agreed upon in the United States prior to the consummation of the sale in Canada. Nevertheless, it was held that the sale resulted in gain from foreign sources.[62]

If, however, a sale purportedly made abroad is a pure sham, it will not be recognized as a separate transaction.[63] In *Kaspare Cohn Co., Ltd.*,[64] an American corporation owned the stock of certain domestic public utilities. It negotiated for the sale of the stock and prepared a sales agreement in New York. A corporation was then organized in Canada and its stock exchanged for the public utilities stock. The sales agreement was thereupon signed and the public utilities stock certificates endorsed and delivered by the Canadian corporation in Canada. The Court in this case did not discuss whether the sale was consummated in Canada but held the Canadian corporation to have been a mere instrumentality of the American corporation which was the real seller.[65] A foreign corporation or a non-resident alien individual, however, which or who really sells domestic securities and endorses and delivers the certificates abroad to United States purchasers, will derive income from foreign sources.[66] If the sale is effected through a U.S. broker and delivery made here, however, title passes in the United States.[67]

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[59] Estate of B. W. Cadwallader, 13 T.C. 214 (1949).

[60] *Elston Co., Ltd.*, 42 B.T.A. 208 (1940); *Hazleton Corp.*, footnote 45, above. It would seem to follow that if a seller mails securities to the purchaser, the sale is consummated at the time when and the place where the securities are put into the mails. The view has been expressed, however, that it is erroneous to analogize the transfer of intangible personal property to situations involving the transfer of tangible goods; *see* Andrew W. Brainerd, "United States Income Taxation of International Sales of Personal Property." *Taxes—The Tax Magazine,* May 1954, Vol. 32, at page 366.

[61] Footnote 45, above.

[62] The case demonstrates the heavy burden the Government has to sustain in order to cause the courts to depart from the title passage test. The form in which the *Hazleton* sale was ultimately put through, appears to have been prompted mainly by tax motives.

[63] *Cf. Ardbern Co., Ltd.* v. *Commissioner* (4 Cir. 1941), 120 F. 2d 424, 27 AFTR 452; *see also Hay* v. *Commissioner* (4 Cir. 1944), 145 F. 2d 1001, 33 AFTR 150, cert. den. 324 U.S. 863 (1945).

[64] 35 B.T.A. 646 (1937). This was the case cited as an illustration of a tax-avoidance sale in G.C.M. 25131.

[65] It impliedly recognized the title passage theory but held that it need not apply it since the sale was not made by the Canadian corporation but by its corporate parent.

[66] *Cf. Elston Co., Ltd.*, footnote 60, above. The rule is the same with respect to foreign or domestic securities.

[67] If a foreign seller executes a separate stock assignment abroad, which is then delivered to the purchaser in the United States together with the stock certificate, it would appear that title also passes in the United States.

The courts have recognized that the complete transfer, for a consideration, of a patent, copyright, trade mark, or similar property, or of an undivided interest therein, constitutes a sale.[68] Thus, a patent owner may sell his patent rights in one country and retain or otherwise exploit his rights in the rest of the world.[69]

According to the presently prevailing trend of opinion, the owner of a copyright who grants the exclusive right to exploit the copyright in a particular medium of publication, such as motion pictures, may effect a transfer and sale even though he reserves for himself the rights for other publication media.[70] If a given transfer does not qualify as a sale but constitutes a license, the compensation received by the licensor, whether it be rentals or royalties, is treated as income from sources within the country in which the granted rights are exercisable.[71] In that event, compensation which is demonstrably allocable to rights exercisable in a foreign country will be deemed income from foreign sources.[72]

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[68] For decisions so holding in the case of domestic taxpayers, *see* among others, *Kronner* v. *U.S.* (Ct. Cls. 1953), 110 F. Supp. 730; *Carruthers* v. *U.S.* (D.C., Ore. 1953), par. 72,427 Prentice-Hall 1953; *Allen* v. *Werner* (5 Cir. 1951), 190 F. 2d 480; *Lamar* v. *Granger* (D.C., W.D. Pa. 1951), 99 F. Supp. 17, 40 AFTR 1246; *Commissioner* v. *Hopkinson* (2 Cir. 1942), 126 F. 2d 406, 28 AFTR 1349; Edward C. Myers, 6 T.C. 258 (1946). *See also* 1954 IRC § 1285, confirming the foregoing rule with respect to patents, and granting long-term capital gain treatment on such sales, in the case of transfers by the inventor or certain other "holders" described in the statute.

For cases dealing with non-resident foreign taxpayers not engaged in business in the United States who grant to U.S. purchasers or transferees world-wide or U.S. rights in patents or literary property, *see Wodehouse* v. *Commissioner*, 337 U.S. 369, 37 AFTR 1363 (1949); *Bloch* v. *Commissioner* (2 Cir. 1952), 200 F. 2d 63; *Misbourne Pictures Ltd.* v. *Johnson* (2 Cir. 1952), 189 F. 2d 774, 40 AFTR 772; *Eterpen Financiera S.R.L.* v. *U.S.* (Ct. Cls. 1952), 108 F. Supp. 100; *Rohmer* v. *Commissioner* (2 Cir. 1946), 153 F. 2d 61, 34 AFTR 826, cert. den. 328 U.S. 862 (1946); *Commissioner* v. *Celanese Corp.* (App. D.C. 1944), 140 F. 2d 339, 32 AFTR 42; *General Aniline & Film Corp.* v. *Commissioner* (2 Cir. 1944), 139 F. 2d 759, 31 AFTR 1136; *Sabatini* v. *Commissioner* (2 Cir. 1938), 98 F. 2d 753, 21 AFTR 800; Kimble Glass Co., 9 T.C. 183 (1947); *Ehrlich* v. *Higgins* (D.C., S.D. N.Y. 1943), 52 F. Supp. 805, 31 AFTR 1180; Estate of Alexander Marton, 47 B.T.A. 184 (1942). Congress has expressly provided that the proceeds from the sale of patents or interests therein, which according to 1954 IRC § 1235 are to be treated as capital gains in the hands of "holders," shall, to the extent that they constitute income from U.S. sources, be taxable to non-resident alien individuals not engaged in business in the United States; 1954 IRC § 871(a). The taxation of non-resident alien individuals engaged in business in the United States, or of foreign corporations, remains unchanged in the new law.

[69] *See Elrod Slug Casting Machine Co.*, par. 47,115 Prentice-Hall Memorandum T.C. (1948) (personal holding company tax case—corporation held to have sold patent rights for certain foreign countries, while it licensed rights for the U.S. and Canada); for a sale of the right to use a tradename in a restricted area, *see Seattle Brewing & Malting Co.*, 6 T.C. 856 (1946), affirmed (9 Cir. 1948) 165 F. 2d 216.

[70] Copyrights, literary and other artistic property are not entitled to capital gain treatment in the hands of the creator or certain of his transferees; *cf.* 1954 IRC §§ 1221(3), 1231(b)(1)(C); 1939 IRC § 117(a)(1)(C), (j). Transfers of such assets, or of rights therein, however, may still constitute sales; *cf.* Rev. Rul. 54-409, 1954 I.R.B. No. 39, page 10. In the aforementioned ruling the Bureau reversed its previous position (I.T. 2735, XII-2 C.B. 131) that a copyright is indivisible, and now holds that the complete transfer of exclusive rights in a part of a copyrighted work may constitute a sale rather than a license, in line with the decision of the Court of Claims in *Herwig* v. *U.S.* (Ct. Cls. 1952), 105 F. Supp. 384, 42 AFTR 147. To the same effect, *see* Joseph A. Fields, 14 T.C. 1202 (1950). For cases expressly or impliedly following the indivisibility theory, *see Rohmer* v. *Commissioner*, *Sabatini* v. *Commissioner*, *Misbourne Pictures Ltd.* v. *Johnson*, footnote 68, above; compare also the majority and dissenting opinions in *Wodehouse* v. *Commissioner*, footnote 68, above.

[71] *Cf.* 1954 IRC §§ 861(a)(4), 862(a)(4); 1939 IRC § 119(a)(4), (c)(4).

[72] For cases involving the allocation of royalty income to foreign rights, compare *Misbourne Pictures Ltd.* v. *Johnson*, footnote 68, above; *Wodehouse* v. *Commissioner* (4 Cir. 1950). 178 F. 2d 987, 38 AFTR 1248, remanding case to Tax Court for allocation, which the lower court

With respect to sales of personal property, the rule of the Internal Revenue Code heretofore described does not distinguish between tangible and intangible property. It provides that the source of income from such sales is to be determined by the place of sale. Neither the Code nor the Regulations nor the case law set forth clear-cut rules regarding the manner in which the place of sale is to be determined in the case of intangible property of the type here discussed.[73]

By analogy to the principles applied in the case of tangible personal property or securities, it would appear that income from the sale of patents, copyrights, trade marks, or other similar property interests, arises at the place where the transferor executes the instrument of transfer and takes all final steps necessary to divest himself of his rights in the property.[74] The tax problems which non-resident alien individuals or foreign corporations encounter in this field may differ from those faced by domestic taxpayers.[75]

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then proceeded to make, 15 T.C. 799 (1950); *id.* (2 Cir. 1949) 177 F. 2d 881, 38 AFTR 998; *Molnar* v. *Commissioner* (2 Cir. 1946), 156 F. 2d 924, 35 AFTR 54; Estate of Alexander Marton, 47 B.T.A. 184 (1942).

[73] It appears that this question has never been clearly presented to the courts in the case of domestic taxpayers. With respect to non-resident alien individuals of foreign corporations, the decisions listed in footnote 68, above, concerned foreign taxpayers not engaged in business in the United States. The courts, therefore, dealt primarily with the question whether income constituted royalties under a license agreement, which was taxable to such recipients as "fixed or determinable annual or periodical" income, or whether it constituted the proceeds of a one-time sale in which case it was not taxable. Having decided that question, it was not necessary for the courts to determine whether a sale gave rise to income from foreign sources.

In the Sabatini case, footnote 68, above, the Board of Tax Appeals had pointed out that the motion picture rights had been sold and that the documents of sale had been executed in England. It therefore stated that the sale of the rights took place in England and that there was no income from U.S. sources; 32 B.T.A. 705, 713 (1935). The Second Circuit reversed, however, because it did not agree that the transaction was a sale. In the subsequent cases, involving non-resident aliens, the question of the place of sale was not clearly discussed. In the Rohmer case, footnote 68, above, the Second Circuit stated that in Sabatini it had assumed that, because the contract was made in England, the transaction would not be taxable if it constituted a sale. It impliedly indicated, however, that in the case of non-resident aliens it was doubtful whether the consideration received for "sales" would ever constitute non-taxable income by reason of the place of sale. The court pointed to its statement in the General Aniline case, footnote 68, above, to the effect that "passage of title does not preclude the existence of royalties."

[74] *E.g.*, the following view has been expressed with respect to non-resident aliens or foreign corporations: "If a foreign author makes an outright sale to a U.S. resident of all the property rights in a particular literary property, then although there are no specific decisions on the point, it appears that no United States tax would be payable, assuming that the alien or foreign corporation was not engaged in business here, or if so engaged, that the sale was consummated outside the United States by execution of the contract and delivery of the property elsewhere"; *see* George S. Allen & Sidney S. Coggan, "Aliens and the Federal Income Tax," *Tax Law Review*, March 1950, Vol. 5, pages 253, 265.

[75] Non-resident alien individuals not engaged in business in the United States will, it appears, be taxed on the income (however denominated) derived from the granting of rights in patents, literary or other similar property, to U.S. residents or corporations, regardless of whether the transaction is characterized as a sale or a license. Still open, however, is the question how the source of income from a sale of foreign rights is to be determined. As regards non-resident individuals engaged in business in the United States, or foreign corporations, it would still appear that a sale of world-wide rights in such property may qualify as a foreign sale if the contract and title documents are executed abroad.

Domestic taxpayers are concerned with the question whether their income from the sale of such rights qualifies as foreign income for purposes of the foreign tax credit or for some of the other purposes enumerated in the text. Here again, if the title passage theory applies, sales of world-wide rights could give rise to sales income from foreign sources, assuming that the conditions for passing title abroad are met. Sales by the original domestic creator of the property, however, will presumably result in income partly from U.S. and partly from foreign sources, if it appears that such transactions involve property produced in the United States and sold abroad.

4. Advantages and Disadvantages of Various Types of Selling Operations

We should distinguish between the types of arrangements to be made by non-resident aliens or foreign entities selling to American purchasers, and those to be made by domestic taxpayers selling abroad.

a. Sales by non-resident aliens and foreign entities. To non-resident alien individuals or foreign entities it is normally advantageous to derive income from foreign, rather than domestic sources.[76] Accordingly, sales by such taxpayers to United States purchasers should take place abroad. It is always advisable to recite in the contract, the invoice and other sales documents that title shall pass at a designated place in a foreign country. The actualities of the sale must conform to such recital. The terms, for example, might be "f.o.b." foreign port or f.o.b. seller's factory or warehouse abroad. If the sale is made "c.i.f." a destination in the United States, it should be made clear that the term "c.i.f." refers to the amount of the price owed by the purchaser and does not designate the place of title passage. The method or time of payment does not as a rule affect the question of title passage.[77] The more customary modes of payment in international transactions may be described as follows:

1. The purchaser establishes a letter of credit. The bank pays against surrender of shipping documents upon delivery of the merchandise to a carrier at the foreign point of shipment. In other cases, partial payment is made at the time of such surrender, the balance of the price falling due at the time when the bank is notified by its correspondent of the arrival of the merchandise.
2. If the parties have frequent business dealings, the "open account" method is often used. Shipping documents are forwarded to the purchaser. At the time of shipment a draft is usually drawn in the amount of the purchase price. This mode of payment presupposes a degree of confidence in the purchaser.
3. The third and somewhat exceptional method is to remit the price by cable at the time of the arrival of the merchandise at the destination. In that case also, the seller may incur a considerable risk.

Although beneficial title may pass abroad even though the seller has the bills of lading issued to himself and takes out insurance coverage in his own name,[78] this procedure should be followed only in exceptional cases. The line between reservation of bare legal title as a security measure and retention of full beneficial ownership is sometimes difficult to draw. Consigning the merchandise to an agent in the United States and having him make delivery to the ultimate American purchaser against payment will not of itself characterize the transaction as a domestic sale.[79] It should be stipulated quite unmistakably, however, that title is intended to pass when delivery is made to the carrier abroad, or at some other time and place outside the United States.[80] Otherwise the conclusion is almost inescapable that the foreign principal has retained title until the agent turns over the merchandise.

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[76] This applies equally to foreign taxpayers engaged in business in the United States, and to those not so engaged.

[77] Footnote 52, above.

[78] *See Ronrico Corp.*, footnote 45, above.

[79] *See Cadwallader,* footnote 59, above; *Briskey Co.*, footnote 51, above.

Foreign sellers residing in countries with which the United States has entered into income tax treaties have somewhat more latitude. Such treaty-country sellers may consign the goods to American agents, so long as the agents are not considered "permanent establishments" within the meaning of the treaties.[81] The merchandise is then surrendered to the purchaser in the United States against payment. In that situation even title passage in the United States will not subject the profits from the sale to U.S. income tax, since commercial profits not attributable to a permanent U.S. establishment are tax-exempt under the treaties.

From the rules set forth in section 3(d) above it follows that a foreign seller of securities should endorse and deliver the certificates abroad. In order to remove any suspicion of a tax avoidance motive, however, the negotiation and execution of the contract should also take place outside the United States. The same procedure should be followed for the transfer of patents, copyrights and similar rights, if such transfer can in other respects qualify as a foreign sale.[82]

b. Direct sales by domestic taxpayers. The elementary precaution of reciting a foreign place of title passage in the sales papers should be observed. Domestic sellers, however, are frequently averse to bearing the risks of loss in transit, and desire to obtain payment either at the time that the merchandise is delivered to a carrier at their warehouse or at the port of shipment. Direct sales may be arranged in the following manner, in order to result in income from foreign sources:

1. The taxpayer establishes branches in foreign countries and ships to them. The branches enter in contracts of sale with the foreign purchasers, and make delivery against payment. Title to the merchandise then passes at the time of delivery. This method of operation results in sales qualifying as foreign sales. It avoids the danger of title passing prior to receipt of payment. Branches in foreign countries may also purchase goods of foreign origin and sell them abroad.

If purchases or sales are effected in foreign currencies, the profits or losses realized from foreign branch operations may be computed on a net worth basis.[83] Under this method, the difference in the net worth at the beginning and the end of the accounting period represents the income of the parent enterprise. Current assets and liabilities are converted into U.S. dollars at the exchange rates prevailing at the beginning and end of the accounting period, while fixed assets and liabilities are computed at the rates existing at the date of acquisition.[84]

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[80] The following clause might be used: "Title to, and risk of loss of, the merchandise shall pass to the purchaser at the time of the delivery of the merchandise at ...." (here insert name of foreign place of delivery).

[81] See footnote 7, above.

[82] While non-resident aliens or foreign corporations not engaged in business in the U.S. can no longer rely on the argument that such income is not "annual or periodical" by reason of its being derived from a sale, they may still claim that it is not from U.S. sources. Care should be taken, therefore, to segregate assignments of foreign rights. The same applies to other taxpayers interested in having income from foreign patents and similar rights characterized as sales proceeds from foreign sources. *See* footnote 75, above.

[83] *Cf. Frederick Vietor & Achelis* v. *Salt's Textile Mfg. Co.* (D.C., Conn. 1928), 26 F. 2d 249, 6 AFTR 7686; A.R.R. 15, 2 C.B. 60; O.D. 489, 2 C.B. 60; G.C.M. 4954, VII-2 C.B. 293.

A foreign branch is subject to the laws of the jurisdiction in which it operates. Usually, the parent enterprise will be held liable for the obligations of the branch. Furthermore, the foreign establishment may have to comply with registration and similar requirements prevailing in the country of operation. The fiscal and other relevant laws of the prospective countries of operation must be carefully examined. It may be advisable to create one main establishment in a favorable jurisdiction abroad, and have that establishment effect sales to other foreign countries.

2. Instead of establishing a separate foreign branch, a domestic taxpayer may conduct his foreign sales operations through agents in foreign countries. In some cases, such agents are mere conduits.[85] Merchandise is consigned to them.[86] They effect the entry and deliver the merchandise to the ultimate customer by endorsing the shipping documents over to him against payment.

In other cases, the foreign agent independently negotiates and consummates sales on behalf of the principal.[87] A basic agreement should be drawn up between principal and agent, stipulating that title to the merchandise shall remain in the principal until delivery is made to the ultimate foreign customer. In both cases, title passes abroad. The books of the principal should reflect sales only at the time when merchandise is delivered by the agent to the foreign purchaser.

Consideration must also be given to the laws of the foreign countries in which the agents operate. The impact of foreign fiscal and other laws, however, is usually less severe in the case of agents than in the case of branch establishments. Many foreign countries permit non-resident business concerns to operate within their territories through "agencies" as distinguished from branches, without subjecting them to tax. Where sales in treaty countries are involved, the business activities of local agents in such countries should be conducted in such a way that the agents will not be treated as permanent establishments of their U.S. principals.[88]

3. If a domestic seller, without the interposition of foreign branches or agents, ships to foreign destinations and specifies in the contract or bill of sale that title shall pass abroad, the transaction may undergo close tax scrutiny in connection with the question whether a *bona fide* foreign sale has been made. In this type of operation, however, the seller is less likely to become subject to the fiscal or other laws of foreign countries.

The direct conduct of foreign sales, whether through branches, agents or otherwise, may for a variety of reasons prove more advantageous than the use of separate legal entities. Losses resulting from foreign sales can be deducted by such direct sellers. Foreign income and similar taxes can be absorbed to a large extent through the foreign tax credit.[89] An American citizen, resident, or domestic corporation, selling directly in countries with which the United States has tax treaties, may receive substantial tax exemptions in such countries, which a foreign corporation will not enjoy.

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[84] *See* full discussion in American Pad and Textile Co., 16 T.C. 1304 (1951), acq. 1951-2 C.B. 1; also Herman Stuetzer Jr., "Tax Problems Raised by Foreign Currency Devaluation and Blocked Foreign Income," *Tax Law Review*, March 1951, Vol. 6, page 255; Marcel Klarmann, "Gains and Losses on Foreign Exchange," *Taxes—The Tax Magazine*, September 1951, Vol. 29, page 717.

[85] *E.g.*, foreign customs or shipping brokers.

[86] Or it may be consigned to seller's order and the shipping documents forwarded to the foreign broker or agent.

[87] This situation should not be confused with that of the independent foreign distributor who purchases from a U.S. supplier and then makes his own sales.

[88] *See* prior discussion in text, section 2(a), and footnote 7, above.

The method of conducting direct sales operations in treaty countries may also be influenced by foreign tax features. Operating through foreign branch establishments or through certain types of agents will cause the U.S. principal to have a permanent establishment in the treaty country, with attendant tax consequences, while straight sales from the United States to the ultimate treaty-country customer, or sales through certain types of local agents, will be tax exempt in the country of destination.[90]

c. Sales through foreign subsidiaries. Domestic taxpayers, whether individual or corporate, may find it advantageous to have their foreign sales separately conducted by one or more foreign corporations or other foreign legal entities.[91] The activities of such foreign subsidiaries would, depending upon the nature of the parent's business, consist of:

1. Purchasing from the parent property produced by the parent in the United States, and selling it abroad;
2. Purchasing from any other U.S. sources property for sale abroad;
3. Producing and selling abroad, either to foreign or U.S. purchasers;
4. Purchasing abroad and selling to U.S. purchasers abroad;
5. Purchasing abroad and selling to foreign purchasers abroad.

The number and nature of foreign subsidiaries[92] to be established will vary with the amount of foreign business anticipated, and according to the tax consequences which would arise in the different foreign countries. The following alternatives may be considered by a domestic taxpayer:

1. Establishing one foreign subsidiary entity to conduct sales in all foreign countries. The subsidiary can either sell directly to all parts of the world or through separate branches or agencies.[93]
2. Creating a number of foreign subsidiaries, one for each major trading area.
3. Creating one foreign subsidiary and having it in turn organize separate foreign subsidiaries.[94]

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[89] If foreign taxes are higher than comparable U.S. taxes, however, they will not be absorbed entirely by the tax credit.

[90] *See* prior discussion of treaties in text, section 2(a).

[91] Foreign legal systems have a number of entities not known to the common law; *e.g.*, the limited liability company known in all civil-law jurisdictions; the establishment or foundation (*cf.* Liechtenstein: Law of Persons and Companies, Arts. 534-551, 552-570). In some cases, consideration may also be given to the trust device as a foreign sales vehicle.

[92] If a closely held domestic corporation contemplates setting up a separate foreign entity, a preliminary question may be whether the corporation itself or its individual stockholders should be the owners or beneficiaries of the foreign entity.

[93] The pattern would normally be to organize in a jurisdiction having no income tax or low tax rates, and selling from there directly to high-tax foreign jurisdictions, with title passing in the jurisdiction of origin. Sales to other foreign countries with favorable tax climates can be made by the subsidiary through branches or agents in such countries.

[94] Only in rare cases would such a course of action be advisable. Double or, if the domestic parent is a corporation, triple taxation may result. Foreign subsidiaries of United Kingdom corporations, for example, which are "managed and controlled" in the United Kingdom may be

If foreign production and sales activities are planned, for example, the production establishment may be incorporated in one country, and various sales subsidiaries in other countries. If the major activities are purchasing rather than producing for resale, one foreign subsidiary may conduct all purchasing activities and either supply the merchandise to its subsidiaries for sale abroad, or resell on its own behalf through branches or agencies in various countries.

Attention must be paid to the taxing systems and tax rates prevailing in the foreign countries. It will normally be advisable to restrict operations in high-tax jurisdictions to sales to customers in such jurisdictions. Foreign corporations are usually taxed only on income derived from sources within the taxing country. Many Latin-American countries tax even their domestic corporations only with respect to income from domestic sources.[95] The Republic of Liberia appears to apply the same principle to Liberian corporations, a majority of whose voting stock is owned by aliens or non-residents.

A number of countries[96] still have low tax rates. The Bahamas,[97] Bermuda, the International Zone of Tangiers,[98] and Nicaragua levy no income tax. The Principality of Liechtenstein[99] and some of the cantons of Switzerland[100] impose no income tax on domestic enterprises not engaged in business within their respective territories, even though such enterprises have an office there. Other jurisdictions, in an effort to attract foreign business, grant substantial concessions such as special tax rates, guarantees against increases in existing tax rates, and complete exemption from certain taxes and import duties.[101] It will therefore be advisable to incorporate in a favorable tax jurisdiction and to handle all foreign sales from an office in that country.

Divorcing foreign sales operations from domestic operations, through the interposition of separate foreign legal entities, presents a number of advantages and disadvantages. Psychological factors must not be underestimated. The indigenous corporation may break down local sales resistance. It may also encounter friendlier

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subject to U.K. income tax on their profits from all sources; *see* F. E. Koch, "Taxation of Foreign Subsidiaries: The Doctrine of Control by English Parent Companies," *Taxes—The Tax Magazine*, October 1950, Vol. 28, page 955.

[95] *E.g.*, Panama: Law No. 52 (1941), as am. by Law No. 49 of September 24, 1946, Art. 1; Venezuela: Law of November 1, 1948, Art. 1; *see also* Uruguay: Law of June 4, 1948.

[96] *E.g.*, Venezuela.

[97] *Cf.* Bahamas Companies Act., c. 83, Art. 18.

[98] Commercial or industrial corporations doing business in Tangiers pay only a license tax, the so-called "patente"; Internat. Legisl. Assembly of Tangiers, Law of July 28, 1938, Art. 1.

[99] Liechtenstein imposes an annual tax amounting to 1/10 of 1% of the capital and a minimum tax of 200 frs. Also, lump-sum tax agreements can be made for the life of a business organization but not in excess of 30 years; *cf.* Liechtenstein: Tax Law of January 11, 1923, as am. May 10, 1924, July 14, 1930, and January 31, 1951.

[100] *See e.g.*, Canton of Geneva Tax Code, Art. 65 (1 per mille of paid-in capital and reserves, and ½ per mille of capital not paid in).

[101] For examples of different methods for attracting foreign capital, adopted by various countries, see among others: Israel: Law for the Encouragement of Capital Investments, of March 29, 1950; Mexico: Law of April 21, 1941, as am.; Panama: Law No. 12, of May 10, 1950; Philippines: Law No. 35 of September 30, 1946; Puerto Rico: Law No. 184, as am.; Turkey: Law No. 6224, of January 18, 1954. For a full discussion of tax and other incentives offered to international business, *see* "The Effects of Taxation on Foreign Trade and Investment," prepared by the United Nations Department of Economic Affairs, *United Nations Publication*, Document No. ST/ECA/1, pages 17-33 (Lake Success, New York, February 1950).

treatment on the part of foreign government agencies. Some foreign countries discriminate against foreign businesses or foreign corporations, either by statute or by unfavorable administrative application of statutes and regulations.[102]

Taxwise, a major item on the credit side of separate foreign subsidiaries is the fact that the income of the foreign entity is not subject to U.S. income tax as long as it is not distributed to the American stockholders. The foreign earnings of the foreign subsidiary can be retained without incurring the risk of their becoming subject to the surtax on unreasonable corporate accumulations.[103] They might eventually be received as capital gains upon the partial or total liquidation of the subsidiary.

Domestic taxpayers have the choice of deferring the tax on wholly "blocked" income.[104] Under the deferral method of reporting blocked income, however, deductions attributable to such income may not be taken until the income ceases to be deferrable. Furthermore, when income ceases to be blocked it must all be reported in the year of receipt, thereby creating the possibility of a disproportionately large tax liability in one year.[105] The funds of separate foreign entities, on the other hand, are not usually blocked in the home countries of such entities.[106]

At the time when the profits of the foreign subsidiary are distributed to the domestic stockholder, taxable income results.[107] A corporate stockholder is entitled to a deduction equal to 85 per cent of dividends received from a domestic corporation,[108] or equal to 85 per cent of a pro-rata portion of dividends received from a foreign corporation which for a stipulated period has been engaged in business, and has derived 50 per cent or more of its income from sources in the United States.[109] In the situation here under discussion, where the foreign subsidiary may receive all or most of its income from foreign sources, a domestic parent corporation cannot deduct dividends received from the subsidiary. Moreover, if the stockholders of the foreign entity are individuals, they will not be able to claim the $50 exclusion[110] or the 4 per cent tax credit[111] for dividends received, since these benefits are confined to distributions made by domestic corporations. A domestic individual stockholder will not receive credit for foreign income taxes incurred on foreign sales by a foreign entity.[112] A domestic corporate stockholder, however, can obtain a partial credit at the time of the receipt of a dividend from a foreign subsidiary, for foreign taxes paid by the subsidiary.[113] Foreign entities cannot file consolidated tax returns with domestic corporations.[114]

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[102] For some examples of discrimination, see Franz Martin Joseph, "Organizing International Businesses," *Taxes—The Tax Magazine*, September 1952, Vol. 30, pages 720-733.

[103] *Cf.* 1954 IRC §§ 531-537; 1939 IRC § 102; *see* Reg. 118, § 39.102-1 (making it clear that these sections apply only to foreign corporations deriving income from sources within the U.S.).

[104] Mim. 6475, 1951-1 C.B. 50, as am. by Mim. 6494, 1950-1 C.B. 54. For case law regarding taxability of blocked income, *cf. Eder* v. *Commissioner* (2 Cir. 1943), 138 F. 2d 27, 31 AFTR 627; Max Freudmann, 10 T.C. 775 (1948); *United Artists Corp. of Japan*, par. 44,210 Prentice-Hall Memorandum T.C. (1944); *International Mortgage & Investment Corp.*, 36 B.T.A. 187 (1937).

[105] *See* Mims. 6475 and 6494, footnote 104, above; also I.T. 4037, 1950-2 C.B. 31; Stuetzer, *op. cit.*, footnote 84, above.

[106] Furthermore, between certain countries transfers may be effected with a considerable amount of freedom; *e.g.*, within the Inter-European Payments Union or the Sterling Area.

[107] The time of distribution, however, can be controlled to a considerable extent, so as to result in income in a year when the stockholder has losses or the benefit of low tax rates. Moreover, as pointed out in the text, long-term capital gain treatment may be obtained in the case of bona fide corporate distributions in total or partial liqudation.

[108] *Cf.* 1954 IRC § 243; 1939 IRC § 26(b) (dividends received "credit").

[109] *Cf.* 1954 IRC § 245; 1939 IRC § 26(b)(3).

[110] 1954 IRC § 116.

[111] 1954 IRC § 34.

Closely held foreign entities exclusively engaged in commercial sales operations are not within the purview of either the "personal holding company" or the "foreign personal holding company" provisions of the Internal Revenue Code.[115] Profits from commercial sales do not fall within the definition of holding company income.[116] On the other hand, it may be dangerous to have the foreign entity receive even a small amount of investment income from United States sources. Since income from foreign sources is not taken into consideration for purposes of determining personal holding company income,[117] it is possible that the foreign entity may be subjected to personal holding company tax liability with respect to its investment income from domestic sources, even though the bulk of its income is derived from foreign sales and even though it shows an over-all loss.[118]

A number of tax problems may arise in connection with transactions between a domestic parent and a foreign subsidiary. If the foreign subsidiary purchases merchandise from the domestic parent, the adequacy of the prices charged by the parent may be questioned. Normally, sales between related entities should be made at arm's-length terms. The Commissioner has the power to re-allocate and re-apportion gross income, deductions and other allowances among controlled taxpayers in order clearly to reflect the income of the taxpayers.[119]

The Code furthermore provides for the disallowance of certain deductions, credits or other tax benefits which would result if one corporation acquires control of another, or of certain property of another, for the "principal purpose" of evading or avoiding Federal income tax, by securing deductions, credits, or other allowances that the acquirer would otherwise not have enjoyed.[120] The 1954 Code stipulates that the acquisition of certain property at a "substantially disproportionate" purchase price shall be *prima facie* evidence of a principal purpose to avoid income taxes.[121] The applicability of this Code section will in most cases depend upon the existence or non-existence of a *bona fide* business purpose. In the case of domestic taxpayers engaged in foreign selling operations, a number of sound business considerations may dictate the establishment of foreign sales subsidiaries. It would appear, therefore, that there would be no substantial danger of the application of the disallowance section in the case of regular commercial activities.

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[112] *But see* income tax conventions with Ireland and the United Kingdom, Arts. XIII (1). Under the terms of those two conventions, a stockholder of a corporation which is a "resident" of the respective foreign countries may claim a tax credit for such Irish or British taxes, as the case may be, paid by the corporation, as are "appropriate to" the dividends received from the corporation.

[113] See footnote 11, above. The credit provided in 1954 IRC § 902(d) would not be applicable to wholly-owned foreign subsidiaries engaged only in selling operations.

[114] 1954 IRC § 1504(b); 1939 IRC § 141(e); Reg. 118, § 39.141-1(c); *but see* 1954 IRC § 1504(d); 1939 IRC § 141(g), Reg. 118, § 39.141-1(e) (subsidiaries formed under Canadian or Mexican law solely in order to comply with the laws of those countries regarding title to and operation of property).

[115] *Cf.* 1954 IRC §§ 515-557; 1939 IRC §§ 331-340 (foreign personal holding companies); 1954 IRC §§ 541-547; 1939 IRC §§ 500-511 (personal holding companies).

[116] *Cf.* 1954 IRC §§ 543, 553; 1939 IRC §§ 332, 502. Income from the sale of patents, copyrights, and similar rights is not deemed to be personal holding company income; *cf. Elrod Slug Casting Machine Co.*, footnote 69, above.

[117] *Cf.* Reg. 118, § 39.500-1(b).

[118] *Cf. Porto Rico Coal Co.* v. *Commissioner* (2 Cir. 1942), 126 F. 2d 212, 28 AFTR 1316.

[119] *Cf.* 1954 IRC § 482; 1939 IRC § 45.

[120] *Cf.* 1954 IRC § 269; 1939 IRC § 129.

[121] 1954 IRC § 269(c). The lightening of the Government's burden of proof in this connection is intended to apply to the acquisition by one corporation of control of another, or to the acquisition of property which has a substituted basis in the hands of the transferee. It would not,

The Code provisions rendering certain corporate exchanges, distributions, or reorganizations tax-free, do not apply to transactions to which a foreign entity is a party, unless the Government has acknowledged beforehand that the contemplated transaction is not in pursuance of a plan having income tax avoidance as one of its principal purposes.[122]

d. Sales in favored territories. As pointed out above, the Internal Revenue Code accords favorable tax treatment to American citizens or domestic corporations engaged in certain operations abroad.

Western Hemisphere Trade Corporations: The ordinary domestic corporation that manufactures and sells,[123] or purchases and sells, both in the United States and in other Western Hemisphere countries, cannot qualify as a Western Hemisphere Trade Corporation.[124] A corporation or individual, expecting to do a substantial amount of business in Western Hemisphere countries, would therefore have to establish a domestic corporation that would do all of its business in the Western Hemisphere. It is doubtful whether corporations having no place of business in a foreign Western Hemisphere country, but conducting all their business by mail from the United States, can qualify.

Western Hemisphere Trade Corporations have certain advantages over foreign corporations.[125] They can avail themselves of the foreign tax credit to the same extent as any other domestic corporation.[126] They may file consolidated tax returns with their domestic affiliates, and their income is not subject to the additional 2 per cent tax otherwise imposed on consolidated income.[127] The domestic parent corporation is entitled to the 85 per cent deduction with respect to dividends received from the Western Hemisphere subsidiary.[128] The Western Hemisphere Trade Corporation enjoys the same non-taxable exchange and distribution benefits as other domestic corporations.[129]

On the other hand, in contrast to foreign entities, the Western Hemisphere cor-

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therefore, encompass ordinary sales of merchandise between a parent and a subsidiary. As to such sales the new law would appear to make no change.

[122] *Cf.* 1954 IRC § 367; 1939 IRC § 112(i); Reg. 118, § 39.112(i)-1. For a special excise tax imposed in certain cases upon transfers of stock or securities by domestic taxpayers to foreign entities, *see* 1954 IRC §§ 1491, 1492; 1939 IRC §§ 1250; 1251.

[123] The domestic manufacturer-seller can never derive income purely from foreign sources; *see* discussion in Section 3(b) of text.

[124] The same applies to corporations selling both to Western Hemisphere and to other foreign countries, although the bare security retention of title in goods shipped to a non-Hemisphere Country will not disqualify a corporation; *cf.* Reg. 118, § 39.109-1; *see also* footnote 22, above, referring to a provision in the 1954 Code with respect to incidental purchases elsewhere.

[125] It should be remembered that they enjoy treaty benefits to the same extent as other domestic corporations. At present the only Western Hemisphere country with which a treaty is in effect, is Canada. It should also be pointed out that Canadian or Mexican subsidiaries of domestic corporations, which fall under the definition of 1954 IRC § 1504(d) (1939 IRC § 141 (9)), can qualify as Western Hemisphere Trade Corporations; *cf.* Rev. Rul. 55-372, 1955-24 I.R.B. 11.

[126] *Cf.* 1954 IRC § 901(b)(1); 1939 IRC § 131(a)(1).

[127] *Cf.* 1954 IRC § 1503(a), (b); 1939 IRC § 141(c); Reg. 118, § 39.141-1(f).

[128] *Cf.* 1954 IRC § 243; 1939 IRC § 26(b)(1).

[129] Under certain conditions, therefore, the parent can liquidate the W. H. subsidiary tax-free.

poration is subject to U.S. income taxation, although at reduced rates,[130] and to the risks of the surtax on unreasonable accumulations of surplus.[131] Transactions between the corporate parent and the Western Hemisphere trade subsidiary are subject to the Commissioner's powers of re-allocation.[132] In a recent ruling it was confirmed that such transactions will be carefully scrutinized with a view to determining whether they were "at arm's length." [133] On the other hand, the Commissioner has ruled that the establishment of a separate corporation for the purpose of taking advantage of the Western Hemisphere provisions will not be considered as an acquisition for tax-avoidance purposes within the meaning of the Code.[134]

Sales from Western Hemisphere countries to the United States can also qualify for Western Hemisphere Trade Corporation treatment.[135] In many cases, however, such operations may be conducted more advantageously through foreign entities, which will not be taxable on income from such foreign sales. The same considerations apply to sales from Western Hemisphere countries to other foreign countries.

Transactions with United States possessions: Not only domestic corporations, but also individual United States citizens may be entitled to the favorable tax treatment accorded to transactions with United States possessions. In view of the high percentage of income which, as mentioned above, must be derived from sources within a United States possession in order to qualify for these tax benefits, taxpayers who derive substantial income from other sources may have to create separate domestic corporations, engaged only in activities in United States possessions. In order to derive sales income from sources within a possession, title must pass within the possession.

Parent-subsidiary transactions are subject to the Commissioner's power of reallocation.[136] The Bureau has not expressly ruled that the creation of a separate corporation for the purpose of obtaining the tax benefits of "Possession operations" will not be considered as an acquisition for the primary purpose of avoiding Federal income taxes. It would appear, however, that the rationale underlying the aforementioned ruling with respect to Western Hemisphere Trade Corporations should equally apply to corporations formed for the purpose of obtaining the tax benefits granted with respect to operations in United States possessions.

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[130] *See* footnote 24, above, for explanation of tax reduction. A domestic parent corporation will ultimately pay tax on 15 per cent of the dividends received from the Western Hemisphere subsidiary. There will still be a substantial over-all tax saving. If the stock of the Western Hemisphere Trade Corporation is owned by individuals, the dividends paid by the corporation will qualify for the dividend exclusion and tax credit.

[131] *Cf.* 1954 IRC §§ 531-537; 1939 IRC § 102. The 1954 Code, however, has considerably softened the impact of this surtax by: (a) granting a so-called "accumulated earnings credit" in a minimum amount of $60,000.00, IRC § 535(c); and (b) throwing upon the Government the burden of proof as to unreasonableness of accumulations, IRC § 534; and (c) establishing standards for the determination of reasonableness by providing that reasonably anticipated business needs must be considered, IRC § 537.

[132] See prior discussion in section 4(c) of text, and footnote 119, above. If income were reallocated by the Commissioner, the subsidiary might no longer fulfill the income requirements of a Western Hemisphere Trade Corporation.

[133] Rev. Rul. 15, 1953-3 I.R.B. 22.

[134] I.T. 3757, 1945 C.B. 200.

[135] *E.g.*, a domestic corporation which produces in a foreign Western Hemisphere country and sells to the United States, with title passing abroad.

[136] *See* footnote 119, above.

The disadvantageous tax factors connected with the establishment of a separate corporation for selling in a United States possession are similar to those encountered in the case of foreign entities.[137] The subsidiary corporation may not file a consolidated tax return with other domestic corporations.[138] The parent corporation cannot claim an 85 per cent deduction for dividends received from such a subsidiary.[139] If the stockholder is an individual he does not obtain the exclusion or the tax credit for dividends distributed by the corporation.[140] For purposes of the foreign tax credit a corporation qualifying for possession benefits is treated like a foreign corporation.[141] It will therefore not be able to claim the credit for taxes paid to foreign countries or to United States possessions.

China Trade Act Corporations: Since the amount of the tax credit depends upon the proportion of income from sources in Hong Kong or Formosa to total income, sales to or from those countries would have to be arranged with a view to title passage therein. The tax problems and consequences are substantially identical with those listed in connection with corporations engaged in operations in United States possessions.[142]

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[137] In effect the Code treats § 931 corporations in most instances like foreign corporations.

[138] 1954 IRC § 1504(b)(4); 1939 IRC § 141(e)(4).

[139] 1954 IRC § 246(a)(2)(B); 1939 IRC § 26(b).

[140] *Cf.* 1954 IRC §§ 34(c)(3)(B) (exclusion); 116 (b)(3)(B)(credit).

[141] 1954 IRC § 901(c)(1); 1939 IRC § 131(g)(1).

[142] A China Trade Act corporation may not file a consolidated return; 1954 IRC § 1504(b)(5); 1939 IRC § 141(e)(5). A domestic parent corporation does not receive an 85 per cent deduction for dividends paid by a China Trade Act corporation; 1954 IRC § 246(a)(1); 1939 IRC § 26(b). Nor will an individual stockholder receive either the dividend exclusion or the dividend credit; 1954 IRC §§ 34(c)(2), 116(b)(2). For purposes of the foreign tax credit the corporation is treated as a foreign one; 1954 IRC § 901(c)(2); 1939 IRC § 131(g)(2).

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19

How to Operate a Business in Bankruptcy or Reorganization Under Chapter X

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A corporation, or an individual operating a business, has been thrown into bankruptcy. The business may be carried on temporarily by a trustee until its assets are marshalled; it may then be liquidated, salvaging for the creditors whatever can be saved. Or the business may be reorganized under Chapter X of the Federal Bankruptcy Act and released from the jurisdiction of the court as a going concern.

Federal taxes typically play a significant role in either situation. A business in bankruptcy has not only most of the tax problems of any other business, but many new ones occasioned by its operation under the aegis of a Federal tribunal.

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2. How and Where the Bankrupt's Tax Claims Are Handled

Virtually at the moment he files his oath of acceptance of office, the trustee in bankruptcy must pay his respects to the Treasury Department. He is required to give immediate notice to the Secretary of the Treasury or his delegate.[1]

The Secretary is enjoined by law to make immediate assessment of all tax claims against the bankrupt or the debtor. No appeal to the Tax Court is permitted a bankrupt or debtor. The insolvent[2] does not receive the usual 90-day letter notifying him of a deficiency that he may appeal to the Tax Court. Instead, he is sent a notice of assessment,[3] and the Bankruptcy Court, which hears claims generally against the estate, becomes the forum for adjudicating tax claims as well. But this process is not carried to the extreme of depriving the Tax Court of jurisdiction of cases which were pending before that body prior to the adjudication of bankruptcy or the filing of a petition under Chapter X. The Tax Court and the Bankruptcy Court appear to have concurrent jurisdiction to determine the insolvent's liability in such cases.[4]

No case decided by the Tax Court prior to the commencement of the proceeding will be retired by the District Court, however.[5] Suits to obtain refunds of taxes paid before the insolvency proceedings were begun may be maintained in either the District Court or the Court of Claims.[6] If a claim for taxes is filed and allowed in the bankruptcy proceeding, the trustee probably may not pay the tax and sue for refund.[7] In such cases, the jurisdiction of the bankruptcy court appears to be exclusive.[8] But if the tax was paid and a refund claim filed *prior* to the adjudication in bankruptcy or the filing of the Chapter X petition, the trustee may pursue the usual remedies of a taxpayer.[9]

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[1] 1954 IRC § 6036; Reg. 118, § 39.275-1(j). This provision applies to trustees in bankruptcy, equity receivers, and a debtor in possession. The penalty for failure to notify the Secretary or his delegate of the proceedings is a suspension of the statute of limitations on the assessment of taxes for a period not to exceed 2 years from the date of the institution of the proceedings. 1954 IRC § 6872. If the notice is given the suspension of the statute terminates 30 days after the date on which the notice is received by the Secretary or his delegate. *Ibid.*

[2] This term is here used generically to refer to the bankrupt and the debtor. It does not necessarily imply an excess of liabilities over assets.

[3] 1954 IRC § 6871. The assessment is not a jeopardy assessment within the meaning of the Code. No formal notice of a deficiency is, therefore, required to be mailed. Nevertheless, it is the practice of the Internal Revenue Service to notify the trustee, receiver, or debtor in possession of the assessment, to furnish the details of the deficiency determination, and to allow opportunity for the submission of evidence and a hearing with respect to the issues. Reg. 118, § 39.274-2.

[4] Section 6871(b) of the 1954 Code provides that claims for deficiency in Federal tax may be presented, for adjudication in accordance with law, to the court before which the bankruptcy or receivership proceeding is pending, despite the pendency of proceedings for the redetermination of the deficiency in pursuance of a petition to the Tax Court . . ." The Tax Court has interpreted this provision as conferring concurrent jurisdiction in such cases on the Tax Court and the Bankruptcy Court. Plains Buying & Selling Assn., 5 B.T.A. 1147 (1927); Robert T. Cunningham, 20 B.T.A. 428 (1930); Missouri Pacific Railroad Co., 30 B.T.A. 587 (1934); see *Monjar* v. *Higgins* (2 Cir. 1943), 132 F. 2d 990, 993, 29 AFTR 625.

[5] Molly-'es Doll-Outfitters, Inc., 38 B.T.A. 1 (1938); see *Matter of Carlisle Packing Co.*, 12 F. Supp. 11, 16 AFTR 736 (D.C. W.D. Wash., 1935), affirmed *sub nomine Kelly* v. *United States* (9 Cir. 1936), 83 F. 2d 783, 17 AFTR 1183, reversed but not on the merits, 300 U.S. 50 (1937); judgment reaffirmed (9 Cir. 1937) 90 F. 2d 73, cert. den. 302 U.S. 730.

[6] See *Sheehan* v. *Hunter* (8 Cir. 1943), 133 F. 2d. 303.

[7] *Cohen* v. *United States* (1 Cir. 1940), 115 F. 2d 505, 25 AFTR 1031; In re General Film Corporation (2 Cir. 1921), 274 Fed. 903, 2 AFTR 1482. This problem is discussed in Morton Pepper, "Income Tax Problems That Come With Bankruptcy," *New York University Sixth Annual Institute on Federal Taxation*, page 735. New York: Matthew Bender and Company, 1948.

No significant changes were made by the Internal Revenue Code of 1954 affecting the handling and administration of taxes in bankruptcy, reorganization or other insolvency proceedings. Generally speaking, therefore, the cases decided under the 1939 Code apply to the new Code.

3. What Current Taxes Have to Be Paid

The debtor or trustee who conducts a business during the period of reorganization is subject to current taxes, payable as administrative expenses, of business generally.[10]

The trustee of a corporate debtor files corporation income tax returns which he executes on behalf of that corporation.[11] He executes waivers and settles tax claims with the Internal Revenue Service, but only with the approval of the Bankruptcy Court.[12]

Vesting title to an insolvent's assets in a trustee is, of course, a non-taxable act.

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[8] *Ibid.*

[9] *Chandler* v. *Nathans* (3 Cir. 1925), 6 F. 2d 725. This problem is discussed in Diamond, "The Relentless Creditor," *Taxes* 1949, Vol. 27, page 325.

[10] See Remington on Bankruptcy (current supplement), § 279; 1954 IRC § 6012(b)(3); 28 U.S.C.A. § 960, which provides that trustees and receivers appointed by the Federal courts shall be subject to State and local taxation. The Supreme Court held that the capital stock tax and its companion, the declared value excess profits tax (these taxes are no longer on the statute books), did not apply to a receiver operating a business, on the theory that the tax was levied on the doing of business in the corporate form. *United States* v. *Whitridge*, 231 U.S. 144 (1913); see Wurzel, "Taxation During Bankruptcy Liquidation," *Harvard Law Review*, May 1942, Vol. 55, page 1141. This decision ignored the realities of receivership and, in turn, Chapter X proceedings, to which it was applied. The Courts applied the same reasoning to the Federal stamp tax on the issuance of bonds and similar certificates of indebtedness, and held that the issuance of trustees' or receivers' certificates, in order to borrow money, even though in a form that would subject the certificates to Federal bond issue tax if issued by the corporation itself, is not taxable. Here too, they held that the issue tax applies only to certificates issued by a corporation but not by a Trustee or receiver. *United States* v. *Powell* (4 Cir. 1938) 95 F. 2d 752, 20 AFTR 1308, *cert. den.* 305 U.S. 619, *United States* v. *Pollard* (5 Cir. 1940), 115 F. 2d 134, 25 AFTR 935. Congress, however, quite properly overruled the stamp tax cases by an amendment to the Code adopted in 1942. 1954 IRC § 4312.

For a discussion of the question as to whether a liquidating trustee in bankruptcy for a corporation is subject to Federal income tax, see Feigenbaum, *The Bankruptcy Triangle*, 30 Taxes 448 (1952).

[11] Reg. 118, § 39.52-2. The Internal Revenue Service has ruled (I.T. 3959, I.R.B. 1949, C.B. 90) that a trustee in bankruptcy has no authority, in his capacity of trustee, to file a Federal income tax return on behalf of a bankrupt individual, and that the bankrupt is required to file his own return for the full taxable year, regardless of bankruptcy. The trustee, as a fiduciary, is required to file a return on Form 1041 for the estate, if its income warrants a return. This return covers the fiscal year elected by the trustee. The tax is determined by reference to § 161, dealing with the taxation of trusts. Morover, any right to a refund of taxes paid prior to bankruptcy passes to the trustee, who may file a claim for refund and recover the overpayment. (*Ibid.*) A holding company, whose interest in an operating subsidiary was declared valueless in a Sec. 77 reorganization of the subsidiary, was not entitled to any part of the subsidiary's income tax saving growing out of the filing of consolidated income tax returns by the holding company with the subsidiary. *Western Pacific Railroad Corp.* v. *Western Pacific Railroad Co.*, 85 F. Supp. 868 (D.C., N.D., Cal. 1949), aff'd 197 F. 2d 994 (9 Cir. 1951), reversed and remanded 345 U.S. 247 (1953), on remand 206 F. 2d 496 (9 Cir. 1953).

[12] Reg. 118, § 39.52-2; G.C.M. 3910, VII-1 C.B. 258.

The basis for the insolvent's assets carries over to the trustee.[13] No documentary stamp taxes are payable on the vesting of title to an insolvent's securities in a trustee or the issuance of new certificates in the name of the trustee.[14] If a proceeding is terminated by a restoration to the insolvent of the assets of an estate, no income or documentary stamp tax is payable on the transfer. In short, despite the long-established rule that a trustee obtains title to the estate of the bankrupt or the debtor, the Internal Revenue Code generally takes this realistic view: a corporation is in substance the owner and operator of its business and the trustee substitutes for its officers and directors.

4. How Withholding Taxes Are Handled

A trustee in bankruptcy must be on the alert for withholding tax problems. Of course, he is obliged to withhold social security and unemployment insurance taxes and income taxes on wages and salaries, and pay these over to the taxing authorities.[15] Interest paid to non-resident aliens and foreign corporations is likewise withheld by the trustee.[16]

Insolvency proceedings present certain problems. Suppose a bankruptcy trustee pays a dividend to wage claimants based on a claim against the bankrupt for services rendered prior to the proceedings—is withholding required for tax purposes? A District Court in Minnesota decided that no withholding was required for unemployment insurance, social security and income taxes, since the trustee was not an "employer" and he had paid no "wages." [17] The Circuit Court of Appeals reversed, however, taking the position that an employer-employee relationship was not prerequisite to the withholding requirement.[18]

The Plan of Reorganization may also present an interest withholding requirement which is not too easily discernible. Where bondholders receive new stock or bonds of the reorganized company in satisfaction of principal as well as accrued, unpaid interest, the Commissioner takes the position that a portion of the new securities represents interest income to the security holders, which is not freed of tax by any provision of the Code.[19] The trustee is consequently required, under such ruling, to withhold and pay over to the Treasury the percentage of the interest required to be paid in the case of nonresident aliens and foreign corporations that are bondholders exchanging under the Plan.[20] The Tax Court, however, has rejected the Commissioner's position in a case in which the exchange of the securities constituted a tax-free reorganization exchange, holding that the interest involved in the exchange is covered by the statute and its decision has been affirmed by the Court of Appeals for the Second Circuit.[21]

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[13] The cases establish the view, as set out in the Regulations, that the trustee acts as such for the Debtor corporation. Reg. 118, § 39.52-2; *Louisville Property Co.* v. *Commissioner* (6 Cir. 1944), 140 F. 2d 547, *cert. den.* 322 U.S. 755; Jacob Rabkin and Mark H. Johnson, *Federal Income Gift and Estate Taxation*, T2 § 1. New York, Matthew Bender and Co., 1950.

[14] Reg. 71, § 113.34(e)(4).

[15] See footnote 18, below.

[16] See footnote 20, below.

[17] In re Inland Waterways, Inc., 71 F. Supp. 134 (D.C. Minn. 1947), 35 AFTR 1290.

[18] *United States* v. *Fogarty* (8 Cir. 1947), 164 F. 2d 26, 36 AFTR 217. *Accord: United States* v. *Curtis* (6 Cir. 1949), 178 F. 2d 268; *Matter of Paul Daigle, Bankrupt*, 114 F. Supp. 109 (D.C., Maine, 1953). It is interesting to note that the Court in the *Fogarty* case classified the withholding taxes as expenses of administration entitled to priority under Section 64-a of the Bankruptcy Act, since the trustee's liability therefore arose when he paid the dividend.

[19] See IRC rulings in reorganization plans of *Erie Railroad Co.*, 423 C.C.H. Federal Tax Service, par. 6,320; *Akron, Canton & Youngstown Railroad Co.*, 443 C.C.H. Federal Tax Service, par. 6,685; *Chicago & North Western Railroad Co.*, 492 C.C.H. Federal Tax Service, par. 747.2257.

5. When Tax Claims Must Be Filed by the Government

Before the Chandler Act was adopted in 1938, the courts held that the provisions of the Bankruptcy Act that claims must be filed within a stated period did not apply to claims of the sovereign.[22] For that reason, bar orders requiring taxing authorities to file their claims came into practice.[23] Frequently, although the periods of the bar orders had expired, the courts allowed tax claims to be proved in cases in which the assets had not been distributed.[24]

The Chandler Act swept away this procedure by expressly requiring that Federal, state and local tax claims be filed within six months after the earliest date set for the first meeting of creditors.[25] Moreover, the courts have held that tax claims like any other claims are barred if filed after the statutory period.[26] The court has the right to grant a reasonable extension of time for the filing of tax claims, provided an application for the extension is made within the prescribed six months' period. This provision has given rise to the nice questions as to whether a modified or supplemental claim filed after the expiration of the statutory period is merely an amendment to a cause of action embodied in a timely claim, or a new cause of action and hence barred.[27]

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[20] See footnote 19 above. The problem may be further complicated in the case of tax-free covenant bonds issued, prior to January 1934, and held by citizens or residents. See 1954 IRC § 1451(a).

[21] *William W. Carman,* 13 T.C. 1029 (1949), aff'd 189 F. 2d 363 (2 Cir. 1951). See also, in accord, *Morris Shanis,* 19 T.C. 641 (1953), Acq. 1954-2 CB 5, aff'd 213 F. 2d 151 (1954).

[22] § 57(n), Bankruptcy Act; In re *Banner Brewing Co.,* 24 F. Supp. 675 (D.C. E.D. Mich., 1938); *United States* v. *Elliott* (6 Cir. 1932), 57 F. 2d 843, 11 AFTR 47. In re *Servel,* 45 F. 2d 660 (D.C. Idaho, 1930) 9 AFTR 671.

[23] In re *Anderson* (2 Cir. 1922), 279 Fed. 525, 2 AFTR 1638; see cases cited in footnote 21 above.

[24] In re *Garfield Bag & Stationery Co.,* 42 F.S. 708 (D.C., S.D. N.Y. 1941); In re *Banner Brewing Co.* and *United States* v. *Elliott,* both footnote 22 above. However, a bar order protected the trustee against any personal liability that might otherwise result from the distribution of the assets.

[25] § 57(n), Bankruptcy Act. This provision does not apply to Chapter X reorganization cases (§ 102, Bankruptcy Act). In a Chapter X case, Federal tax claims are required to be satisfied or dealt with in the plan of reorganization in a manner satisfactory to the Federal Government. Nevertheless, the bar order procedure is still used in Chapter X proceedings to obtain the filing of tax claims. See Diamond, footnote 9, above. The Court, in a reorganization case, nevertheless retains extensive jurisdiction to deal with tax problems. This is indicated by the case of In re *Boston Coal Co.,* 81 F. Supp. 508 (D.C., Md. 1949), in which, after the confirmation of a plan of reorganization, the Court reopened the entire proceeding in order to make provision for the satisfaction of tax claims, indicating that it might be impossible to consummate the plan and that an order of bankruptcy might be entered.

In a novel opinion, and indeed one which runs counter to accepted conceptions of the role of the tax collector in bankruptcy proceedings, a three-judge Federal Court in Colorado, in a railroad adjustment proceeding under Chapter XV of the Bankruptcy Act, rejected a Federal income tax because it was proposed three and one half years after the plan had been approved. In re *The Colorado & Southern Railway Co.,* 84 F. Supp. 134 (D.C. Colo., 1949), cert. den. 338 U.S. 847. The claim was not barred by the statute of limitations, but it was rejected as "unjust, inequitable and unlawful" because no claim was made at the time the plan was under consideration, and if the claim had been successfully asserted in the proceedings, there would have been no Chapter XV plan which could have been approved by the Court or which would have been assented to by the bondholders and stockholders.

It should be borne in mind that a discharge in a straight bankruptcy proceeding does not relieve the bankrupt of liability for Federal taxes (§ 17(1), Bankruptcy Act).

[26] In re *Paragon Novelty Bag Co.* (2 Cir. 1943), 135 F. 2d 210; *cf.* In re *Colorado & Southern Ry.,* 84 F. Supp. 134 (D.C. Colorado, 1949).

6. How the Amount of Tax Liability Is Determined

As a claimant against the estate, the Government theoretically has the burden of establishing its tax claim, but in fact the mere proof of an assessment establishes a prima facie case.[28] The burden of demonstrating the incorrectness of the assessment is laid upon the trustee.[29]

A judgment of the District Court in a tax claim proceeding is reviewable by the U.S. Court of Appeals under the same procedure as for other provable claims in bankruptcy.[30] A creditor objecting to the allowance of a tax claim that has been compromised by the government and the trustee, may appeal from the District Court's order that approves the compromise. However, the Court will reverse only if the Bankruptcy Court has abused its discretion in approving the compromise.[31]

7. Tax Liens and Priorities

The estate itself must be preserved during the pendency of the proceedings. Current taxes accruing during the proceedings must therefore be paid along with other administrative expenses before claimants generally.[32]

Holders of liens on the property of the insolvent must be paid in full before the Federal Government collects anything on account of taxes accruing *prior* to bankruptcy.[33] But tax claims may also have ripened into liens. Ordinarily, when a Federal tax has been assessed, it becomes a lien upon all the assets of the taxpayer.[34] Federal tax liens usually have no force against a subsequent mortgagee, purchaser or judgment creditor, unless the assessment has been recorded in compliance with local statutes.[35]

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[27] § 64(a), Bankruptcy Act; *Industrial Commissioner of New York* v. *Schneider* (2 Cir. 1947), 162 F. 2d 847; In re *Casey*, 53 F. Supp. 879 (D.C. S.D., N.Y., 1943).

[28] *Fiori* v. *Rothensies* (3 Cir. 1938), 99 F. 2d 922, 21 AFTR 1224; In re *General Film Corporation* (2 Cir. 1921), 274 F. 2d 903, 2 AFTR 1482; In re *Clayton Magazines, Inc.* (2 Cir. 1935), 77 F. 2d 852, 16 AFTR 200; *Paschal* v. *Blieden* (8 Cir. 1942), 127 F. 2d 398, 29 AFTR 286. See Diamond, footnote 9, above.

[29] In re *Noble*, 15 F. Supp. 648 (D.C., W.D., N.Y., 1936) 19 AFTR 1.

[30] *United States* v. *Bernstein* (8 Cir. 1926), 16 F. 2d 233. Appeals are governed by § 24 and § 25 of the Bankruptcy Act.

[31] In re *Prudence Company* (2 Cir. 1938), 98 F. 2d 559, 22 AFTR 14, *cert. den.* 306 U.S. 636 (1939).

[32] § 64, Bankruptcy Act. As to straight bankruptcy cases, see § 64(a) 1, Bankruptcy Act; In re *Lambertville Rubber Co., Inc.* (3 Cir. 1940), 111 F. 2d 45. As to Chapter X cases, see In re *Pressed Steel Car Co. of New Jersey* (3 Cir. 1938), 100 F. 2d 147; *cert. den. sub nominee, Wick* v. *State of New Jersey*, 306 U.S. 648 (1939); *United Shipyards, Inc.* v. *Hoey* (2 Cir. 1942), 131 F. 2d 525, *cert. denied* 318 U.S. 791 (1943). As to the question concerning the extent to which administrative expenses may be required to be borne by the holder of a lien on the Bankrupt's property, see *Collier on Bankruptcy*, 14th edition, Vol. 4, par. 70.99.

[33] 1954 IRC § 6323; par. 52,786 C.C.H. Bankruptcy Law Service. Liens for taxes are valid against the trustee even though arising while the debtor is insolvent and within four months prior to the filing of the petition if they are perfected in accordance with the laws creating them. § 67(b) and (c) Bankruptcy Act, as amended by P.L. 456, 82d Cong. 2d Sess.

If no creditor, including the Federal Government, has a lien, the common law rule is that the sovereign must be paid ahead of general creditors, after administration expenses have been provided for.[36] The Bankruptcy Act has adopted that rule in straight bankruptcy proceedings, except for a special preference afforded wage claims for the three-month period prior to the adjudication.[37] The order of non-lien priorities is: administration expenses, wage claims for three months prior to adjudication, and then taxes.[38] In proceedings under Chapter X, the courts will generally follow State laws and recognize special priorities accordingly.

8. Penalties and Interest on Taxes

Tax penalties are not allowable in bankruptcy proceedings, except for pecuniary losses sustained by the act or omission to act which gave rise to the penalty.[39] This rule applies only to pre-bankruptcy penalties; it does not prevent the collection of penalties from an estate on account of current taxes incurred by the trustee while he is operating the business.[40]

Interest accrued on taxes to the date of bankruptcy constitutes a valid claim against the estate. The principle that interest is not allowed on the claims of creditors generally after the date of bankruptcy is a long-established one.[41] More recently, the Supreme Court applied this same principle to tax claims which arose *prior* to bankruptcy, disallowing post-bankruptcy interest on such claims.[42]

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[34] 1954 IRC §§ 6321-6322. The lien also attaches to after-acquired property. *Glass City Bank of Jeanette* v. *United States,* 326 U.S. 265 (1945). A statutory tax lien perfected by taking possession of the bankrupt's assets prior to the filing of the petition in bankruptcy retains its priority over wage claims even though the collector turned the assets over to the trustee for sale subject to lien. *Goggin* v. *Division of Labor Law Enforcement,* 336 U.S. 118 (1949). Under Section 67(c) statutory liens are subordinated to administrative expenses and wage claims only where the liens are not perfected by possession of the assets. Amendments to the Bankruptcy Act adopted in 1952 require nonrecognition of statutory liens on personal property, including liens for debts owed to the states or their subdivisions, unless accompanied by levy, possession, etc. See P.L. 456, 82d Cong. 2d Sess., amending § 67(c), Bankruptcy Act.

[35] 1954 IRC §6323. In the case of the estate tax, however, the lien attaches for a 10-year period from the date of the decedent's death without assessment or recording. 1954 IRC § 6324; *Detroit Bank* v. *United States,* 317 U.S. 329 (1943).

[36] *Central Trust Co. of N.Y.* v. *N.Y.C. & Northern R.R. Co.,* 110 N.Y. 250 (1888); *Matter of Atlas Television Co.,* 273 N.Y. 51 (1936). See *United States* v. *Gilbert Associates, Inc.,* 345 U.S. 361 (1953). For a general consideration of Federal tax liens in bankruptcy, see Feigenbaum, *The Bankruptcy Triangle,* 30 Taxes 448 (1952).

[37] § 64a, Bankruptcy Act.

[38] See 10 *Remington on Bankruptcy,* § 4571 *et seq.*

[39] § 57(j), Bankruptcy Act; *United States* v. *Childs,* 266 U.S. 304 (1924). This provision does not apply to Chapter X cases. § 102, Bankruptcy Act. What constitutes a penalty, as distinguished from interest, has given rise to considerable controversy. See *United States* v. *Childs,* above; Matter of Seamon (2 Cir. 1935), 80 F. 2d 81. The 1952 amendments to the Bankruptcy Act made it clear that interest on penalties assessed by the government will be allowed only on the actual pecuniary loss suffered. See P.L. 456, 82d Cong., 2d Sess., amending § 57(j), Bankruptcy Act.

[40] *Boteler* v. *Ingels,* 308 U.S. 57 (1939). The trustee may be subject to surcharge for a penalty collected from the estate where the penalty resulted from his dereliction.

[41] *Sexton* v. *Dreyfus,* 219 U.S. 344 (1911).

9. Seizure of Assets to Pay Taxes

Because the assets of the estate are being administered by the court, creditors and lien holders may not seize them. That rule applies to the Internal Revenue Service.[43] Distraint is unnecessary, of course, since the court will protect the property from dissipation and will safeguard the government in its rights. The Federal Government, like any other creditor desiring prompt payment, may seek a court order directing a debtor or trustee to pay taxes.[44] The court may in its discretion refuse to order immediate payment if the payment will disturb or embarrass the purposes of the reorganization.[45]

10. Deduction of Interest Accruing on Debt During Insolvency Proceedings

May a debtor in reorganization deduct interest accruing on its obligations during the course of the proceedings? Typically, the interest may be totally or partially unpaid during the period of reorganization. In *Zimmerman Steel Co.* v. *Commissioner*, the Court of Appeals for the Eighth Circuit held that a taxpayer on the accrual basis, whose financial condition was such that there was no reasonable expectation that interest on its obligations would be paid, is nevertheless entitled to a deduction for accrued, unpaid interest.[46] The court took the position that the liability for the payment of interest in fact accrued on the indebtedness; that no other requirement for a deduction for accrued interest exists in the statute, and, accordingly, that the financial condition of the taxpayer and the unlikelihood of payment were immaterial. The Tax Court had disallowed the deduction, but the then Bureau of Internal Revenue adopted the Circuit Court's view in its rulings and finally, with some reluctance, the Tax Court fell into line.[47]

11. Deductions for Worthless Stock and Bad Debts

The stockholders of a corporation which has been adjudicated a bankrupt are commonly thought to be entitled to a worthless stock deduction in the year of adjudication. This is not always the case, for the stock may have become worthless before, during or subsequent to the year of bankruptcy.[48] Bankruptcy is merely one of the facts to be considered—an important,[49] but not necessarily a decisive, fact.

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[42] *City of New York* v. *Saper*, 336 U.S. 328 (1949). As to the applicability of this decision to Chapter X cases, see *Matter of Caroline Mills, Inc.*, 97 F.S. 793 (D.C. E.D. S.C. 1950), aff'd 189 F. 2d 876 (C.A. 4, 1951).

[43] Reg. 118, § 39.274-1; In re *California Pea Products*, 37 F. Supp. 658 (D.C. Cal., 1941).

[44] See In re *Philadelphia & Reading Coal Co.* (D.C. Pa., 1942), par. 53,808 C.C.H. Bankruptcy Law Service.

[45] *Ibid.*

[46] *Zimmerman Steel Co.* v. *United States* (8 Cir. 1942), 130 F. 2d 1011, 30 AFTR 41.

[47] 45 B.T.A. 1041 (1942); I.T. 3635, 1944 C.B. 101; Butler Consolidated Coal Co., 6 T.C. 183 (1946). See, however, *Florence Pearlman*, 4 T.C. 34 (1944), aff'd 153 F. 2d 560 (C.A. 3, 1946), in which the Tax Court respectfully indicated its adherence to its own views in the *Zimmerman Steel Company* case, despite the reversal of its decision by the Eighth Circuit. See also *Chas. Schaefer & Son, Inc.*, 20 T.C. 558 (1953).

In the case of preferred stock and especially in the case of debts of the insolvent, holders of securities have a better chance of recovering a part of their claims than do common stockholders. Therefore, mere proof of the corporation's adjudication in bankruptcy will not give rise to a worthless security or bad debt deduction.[50]

12. Reorganization Plans Under Chapter X

The reorganization of a corporation is the primary objective in a proceeding under Chapter X. A corporation and its stockholders are greatly affected, taxwise, by steps taken in a plan of reorganization.

The debtor or trustee will ordinarily want to do the following:

1. Keep the same tax basis of the assets for the reorganized company as they had in the hands of the insolvent. Normally, the assets owned by the insolvent were bought at prices higher than their present values. In most cases, the reorganized corporation will suffer a loss in basis if the fair market value of the acquired assets is to be their tax basis.
2. Carry out a tax-free exchange of securities under the reorganization plan, so that no gain or loss will be recognized on such exchanges, and the basis of securities held in the insolvent will be carried over to new securities of the reorganized corporation.
3. Retain for the reorganized company the benefit of any carryovers of capital losses or net operating losses that were available to the insolvent.

In some cases, a tax-free reorganization may be disadvantageous. With the continued high cost of capital assets, the market values of assets owned by an insolvent may exceed their tax basis. The basis of the assets to the insolvent would thus be less desirable than a basis measured by market value. In the typical case, however, the goal will be a plan that is nontaxable to the stock and security holders and which retains the insolvent's basis for the assets of the reorganized corporation.

13. Special Insolvency Reorganization Provisions

A general analysis of tax-free reorganizations will not be attempted.[51] Consideration should be given, however, to the special provisions of the Internal Revenue Code concerning reorganization in bankruptcy and receivership.[52]

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[48] See *George W. Schoenhut*, 45 B.T.A. 812 (1941); *G. E. Cotton*, 25 B.T.A. 866 (1932); *Jarvis* v. *Heiner* (3 Cir. 1930), 39 F. 2d 361, 8 AFTR 10508; *Atlantic Coastline R.R. Co.*, 4 T.C. 140 (1944). See Morton Pepper, "Income Tax Problems That Come with Bankruptcy," *New York University Sixth Annual Institute on Federal Taxation*, page 734. New York: Matthew Bender and Company, 1948.

[49] *Coosa Land Co.* v. *Commissioner* (5 Cir. 1939), 103 F. 2d 555, 22 AFTR 1089.

[50] *P. H. Gill & Sons Forge & Machine Works*, 7 B.T.A. 1146 (1927); *Atlantic Coastline R.R. Co.*, 4 T.C. 140 (1944).

[51] For analyses of reorganizations generally, see Randolph E. Paul, *Studies in Federal Taxation* (third series, 1940), Chap. 2; Clarence Castimore, "Effect of Recent Decisions Upon Reorganization and Basis Problems," *New York University Third Annual Institute on Federal Taxation*, page 130 *et seq*. New York: Matthew Bender and Company, 1945. Jacob Rabkin, "A Commentary on Reorganizations," *idem*, page 148 *et seq*.

a. The background of the insolvency reorganization provisions. No special provisions governing insolvency reorganizations appeared in the Code before 1943. Only if the requirements of Section 112 were met was a reorganization or tax-free exchange in an insolvency proceeding possible.[53] Bureau interpretations and court decisions that certain insolvency reorganizations did not constitute tax-free reorganizations had caused considerable dissatisfaction for some time.[54] All this was brought to a climax by the Supreme Court's decision in the *Southwest Consolidated Corporation* case, that although a typical reorganization pattern had been followed in general, a tax-free reorganization had not taken place in an equity receivership.[55] The creditors' committee in that case had bought the assets of the insolvent, then transferred them to a new corporation. The old company's bondholders exchanged their bonds for stock in the new company. Valuable stock purchase warrants were issued to the stockholders and general creditors of the insolvent. A bank loan, made to settle with bondholders who did not assent, was also paid off by the new corporation. The court held that, since the consideration given by the new corporation for the property of the old was not "solely voting" stock, a tax-free reorganization had not been accomplished. The assumptions of the bank loan and warrants were consideration other than "voting stock"; and, since the funds secured under the bank loan paid off some of the bondholders, the court held that the loan did not constitute a type of indebtedness that could be disregarded. As a result, the new company could not retain the basis for the assets that they had in the hands of the old corporation.

b. The insolvency reorganization provisions. In 1943, Congress liberalized and broadened the provisions of the Code dealing with foreclosure proceedings and insolvency reorganizations in order to remove such restrictions. The new provisions carried over without change into the 1954 Code in Sections 371 and 372, were designed to assure that:

1. The transaction is tax-free to the insolvent making the transfer.
2. Assets retain the insolvent's basis when acquired by the reorganized company.
3. Security holders of the old company who exchange securities of the insolvent for securities of the reorganized company realize no recognized gain or loss.

c. Section 371. Section 371 should now be analyzed to determine the steps required for a reorganization under its provisions. This section is particularly important because the other sections refer back to it for a definition of the kinds of cases covered. The following characteristics are necessary to qualify under Section 371.

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[52] §§ 112(b)(10), 112(1), and 113(a)(22) of the 1939 Code now embodied in § 371 and § 372 of the 1954 Code. These provisions also apply to reorganizations effectuated through foreclosure proceedings. For a discussion of the insolvency reorganization provisions, see Hellerstein, "Federal Tax Problems in Bankruptcy and Reorganization Proceedings," *New York University Fourth Annual Institute on Federal Taxation*, page 545. New York: Matthew Bender and Company, 1946.

[53] The mere fact that there is a reorganization in an insolvency proceeding does not establish that there is a tax-free reorganization under the Code. See footnote 54, below.

[54] See generally on this subject, Norris Darrell, "Creditors and Reorganizations and the Federal Income Tax," 7 *Harvard Law Review* 1944, Vol. 57, page 1009.

[55] *Commissioner* v. *Southwest Consolidated Corp.*, 315 U.S. 194 (1942).

1. A corporation, other than a railroad (a special provision covers railroads[56]), must be involved in a proceeding under Section 77B or Chapter X of the Bankruptcy Law, or in foreclosure, receivership or similar proceedings.

2. A transfer by such a corporation of property must take place under an order of the court having jurisdiction in the proceeding.

3. The transfer must be made to another corporation "organized or made use of to effectuate a plan of reorganization approved by the court."

4. The transaction must be made in exchange "solely for stock or securities" in the new corporation.

This is the over-all pattern: A transfer of property under a court order, by a corporation in one of the specified proceedings to another corporation organized or made use of to effectuate the plan, comes under Section 371. Under such circumstances, security holders of the old company who surrender securities of the insolvent for securities of the reorganized company realize no gain or loss; the transaction is tax-free to the insolvent who makes the transfer; the reorganized company retains the insolvent's basis for the assets acquired.

d. The "boot" provisions. The so-called "boot" provisions[57] allow reorganization exchanges in which a corporation or security holder may receive cash or other property in addition to securities, and maintain the tax-free character of the reorganization.[58] In particular types of reorganizations requiring the corporation that receives the property to transfer voting stock only in exchange, payment of cash or other "boot" does make the exchange taxable.[59] The reorganization of the *Southwest Consolidated Corporation* was struck down by the Supreme Court on these grounds.[60]

It is now expressly provided that a transfer does not lose its non-taxable status in insolvency reorganizations merely because the corporation receiving the property pays cash or other property besides issuing voting stock or other securities.[61] Except for the cash or other boot, the transaction remains non-taxable. Determination as to whether an insolvency reorganization is tax-free occurs under Section 371, not Section 368. The transferee may pay cash or other property as a consideration in addition to stock or securities, without destroying the tax-free nature of the transfer and the additional payment becomes taxable "boot."[62] However, the provision contained in the insolvency sections as originally enacted, authorizing the taxation of "boot" as a dividend in circumstances where the boot was deemed to have the effect of the distribution of a taxable dividend, was removed by the 1954 Code.[63]

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[56] Railroad reorganizations and receivership are covered by IRC § 373 of the 1954 Code.

[57] 1954 IRC § 356.

[58] For example, a transfer falling within the provisions of 1954 IRC § 368(a)(A)(1)(D).

[59] This is the case in situations in which the taxpayer seeks to qualify the transaction under clauses (B) or (C) of 1954 IRC § 368(a)(1).

[60] See footnote 55, above.

[61] 1954 IRC § 371.

[62] § 371(a)(2).

[63] Compare Section 112(c)(2) of the 1939 Code with Section 371(a)(2) and (b)(2) of the 1954 Code.

As a result, an insolvency reorganization is tax-free even though bonds, stock warrants, cash or other property are paid to the old security holders in addition to voting stock. Reorganization of insolvent corporations in judicial proceedings on a tax-free basis has thus been made easier.[64]

e. Continuity of interest. The insolvency provisions of the Code do not annul the continuity of interest rule.[65] The necessity for a "continuity of interest" in the reorganized business has been a major pitfall in the achievement of tax-free reorganizations. The regulations require "a continuity of the business enterprise under the modified corporate form and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization." [66]

The Supreme Court in *Helvering* v. *Alabama Asphaltic Corporation*, in 1942, held that for the purpose of determining continuity of interest, creditors of an insolvent corporation are to be considered the owners of the equity in the corporation when they have taken action to enforce their rights.[67] By taking command of the assets, they have gained a proprietary interest in the corporation, the court said. Therefore, the continuity of interest rule is satisfied when creditors acquire stock of a reorganized company in exchange for their previous claims against the insolvent. They have merely formalized their proprietary holding.

The regulations under insolvency reorganization provisions embody the rule laid down in the *Alabama Asphaltic* case. They state that "the interest of creditors who have, by appropriate legal steps, obtained effective command of the property of an insolvent corporation is considered as the equivalent of a proprietary interest." [68] A "mere possibility of a proprietary interest" [69] is insufficient. The "controlling factors are the corporation's insolvency and the effective command by the creditors over its property." [70] "Insolvency" is defined by the regulations as "insolvency at *any time during the course of the proceeding* . . .

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[64] In proposing the insolvency reorganization provisions, the Congressional committees emphasized the point that the mechanics of the reorganization are not to govern the tax results. Conference Committee Report, Revenue Act of 1943. The transaction may take the form of a transfer of the property of the insolvent to its bondholders in exchange for their bonds, to be followed by a transfer of the property to the new corporation in exchange for its stock; or the bonds may be transferred directly to the new corporation by the bondholders in exchange for the corporation's stock, with a surrender of the bonds by the new corporation to the insolvent for the latter's assets. Either method will get the same tax result. Both will be tax-free.

[65] "It is intended, however, that only an actual reorganization of a corporation will be covered as distinguished from a liquidation in a bankruptcy proceeding and sale of property to either new or old interests supplying new capital and discharging the obligations of the old corporation." Conference Committee Report, Revenue Act of 1943; see also, Senate Committee Report, page 50. For cases denying the applicability of the 1939 Code provision § 112(b)(10), for lack of the requisite continuity of interest see *Chicago Stadium Corp.*, 13 T.C. 889; *Harbor Building Trust*, 16 T.C. 1321.

[66] Reg. 118, § 39.112(b)(10)-1(4), repeated in proposed Regulations issued under 1954 Code. See § 1.371-1(4).

[67] *Helvering* v. *Alabama Asphaltic Corporation*, 315 U.S. 179 (1942), 28 AFTR 567. For a consideration of the continuity of interest problem generally, see Erwin Griswold, "Securities and Continuity of Interest," *Harvard Law Review*, May 1945, Vol. 58, page 705.

[68] Reg. 118, § 39.112(b)(10)-1(4), repeated in proposed Regulations issued under 1954 Code. See § 1.371-1(4).

[69] *Ibid.*

[70] *Ibid.*

either in the sense of excess of liabilities over assets or in the sense of inability to meet obligations as they mature." [71]

These requirements must now be related to proceedings under Chapter X. The court will not approve the petition in such a proceeding unless it is satisfied that the "corporation is insolvent or unable to pay its debts as they mature." [72] This rule is required by statute under Chapter X; the petition will be dismissed by the court unless it has been met. Insolvency in either the equity or bankruptcy sense is, therefore, almost automatically a feature of reorganizations under Chapter X. Approval of a petition in a Chapter X case by the court demonstrates that creditors have taken command over the property to safeguard their proprietary interest in the corporation.[73]

The *Alabama Asphaltic* case also applies if the plan of reorganization simply eliminates the old stockholders and substitutes the creditors of the insolvent as stockholders of the reorganized corporation. Here the requirement of a continuity of interest is readily met.

On the other hand, Section 371 seems applicable even if bondholders or other creditors do not make a *complete* shift from creditor to equity standing. Thus, if both bonds and stocks are given to the bondholders of the debtor, the interest of these bondholders in the new company remains as it was during the insolvency proceedings—that is, partially as the interest of creditors and partially as that of owners of equity in the enterprise.[74] If mortgage bondholders receive new bonds *in toto*, junior bondholders receive a portion of the common stock and old stockholders are given the remainder of the common stock, the rule appears to be the same.[75] The doctrine of the *Alabama Asphaltic* case is that each class of security holders participating under a plan is given the interest in the company that it acquired with "effective command over the property" of the insolvent.[76] In reorganizations of debtor corporations under Chapter X, little difficulty in proving the required continuity of interest should ordinarily be experienced, despite the emphasis on its importance in the regulations.

f. Liquidations of corporations and business purpose. The notion of a continuity of interest is predicated upon a reorganization, not a liquidation sale. That the insolvency reorganization provisions do not apply to corporations liquidating and selling their property to old or new interests that supply capital to settle the obligations of the insolvent, is emphasized by the reports of the Congressional Committees recommending their adoption.[77] In other words, any attempt to carry out a sale in bankruptcy or liquidation in the form of a reorganization is likely to fail. The business purpose doctrine of the *Gregory* case must also be taken into account, the Committees warned. A reorganization in an insolvency proceeding is carried out under judicial decree, but it must have some business purpose other than the mere avoidance of taxes or it will not accomplish that result.[78]

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[71] *Ibid.*; our emphasis.

[72] §§ 130(1), 141, Bankruptcy Act.

[73] Nevertheless a formal finding of insolvency, as defined by the Regulations, should be a useful document in dealing with the Treasury Department.

[74] The cases arising under § 112(g)(1) of the 1939 Code relating to tax-free reorganizations generally, which hold that there is a sufficient continuity of interest where persons who formerly held stocks and bonds of a corporation come out of the transaction owning only voting stock, support the conclusion suggested in the text. See *Commissioner* v. *Huntzinger* (10 Cir. 1943), 137 F. 2d 128, 31 AFTR 355; *Prairie du Chien-Marquette Bridge Co.* v. *Commissioner* (3 Cir. 1944), 142 F. 2d 624, 32 AFTR 701; see Castimore *loc. cit.*, footnote 51, above. In addition, it should be noted that the acquisition of preferred non-voting stock of the transferee corporation has been held to satisfy the continuity of interest requirement. *Nelson Company* v. *Helvering*, 296 U.S. 374 (1935). Moreover, to the extent that the bondholders exchange their bonds for bonds, there was a tax-free recapitalization under IRC § 112(g)(1)(E). See *Commissioner* v. *Neustadt's Trust* (2 Cir. 1942), 131 F. 2d 528, 30 AFTR 320.

[75] *Ibid.*

[76] See footnote 67, above.

g. The position of the security holder. If a reorganization meets all the above requirements, not only is the transfer non-taxable to the insolvent corporation, affording a continuance of basis to the new company, but the security holders also exchange old securities for new under the plan free of tax.[79]

The tax-free exchange provisions do not apply to a creditor who does not hold a "security"—e.g., an open account claimant or the holder of a short term note.[80] They are applicable only to holders of securities.[81]

14. Debt Cancellation and the Basis Provisions

Section 268 of the Bankruptcy Act, as enacted in 1938, provided that no taxable income was to be realized by a debtor in a reorganization under Chapter X, a trustee, or a corporation organized or made use of for carrying out a reorganization plan, by the modification or cancellation of any indebtedness of the debtor. Thus, modifications or cancellations of debt in effectuating a Chapter X reorganization did not come under the doctrine of the *Kirby Lumber Company*[82] case. But the tax on income from debt cancellation was not eliminated without a *quid pro quo*. The debtor paid in the form of a reduction of asset basis by the amount of the reduction of asset basis by the amount of the cancellation or recancellation or reduction in indebtedness.[83] The fair market value of the assets was the lowest point to which their basis could be reduced, however.[84] Nevertheless, this reduction in tax basis was a serious matter, especially with regard to depreciable property.[85]

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[77] "It is intended, however, that only an actual reorganization of a corporation will be covered as distinguished from a liquidation in a bankruptcy proceeding and sale of property to either new or old interests supplying new capital and discharging the obligations of the old corporation. In other words, the type of transaction which was held not to be a reorganization under § 112(g)(1) in the *Mascot Stove Co.* case (120 F. 2d 153) [27 AFTR 389] or in *Templetons Jewelers Inc.* case (126 F. 2d 251) [28 AFTR 1319] would likewise not be covered under these amendments." Conference Committee Report, Revenue Act of 1943; see also Senate Finance Committee Report, page 50.

[78] "It is also intended that the business purpose test enunciated in *Gregory* v. *Helvering* (293 U.S. 465) shall likewise apply to transactions under these amendments." Conference Committee Report, Revenue Act of 1943; see also Senate Finance Committee Report, page 50. Moreover, not every transfer by a corporation in an insolvency proceeding is covered by the text. The provisions appear to be limited, although they do not precisely say so, to transfers designed to effectuate the plan of reorganization. See 1954 IRC § 371.

[79] In *Benedum* v. *Granger*, 180 F. 2d 564 (3 Cir. 1950), a bad debt deduction was denied to a bondholder under § 112(e), where he exchanged bonds for stock in a § 77B reorganization.

[80] For a discussion of the meaning of the term "securities," see Griswold, *loc. cit.*, footnote 67, above.

[81] 1954 IRC § 371. There is one important innovation in language, at least with respect to security holders. The general reorganization provisions deal with exchanges. The insolvency provisions cover the case of a mere "extinguishment" of an interest in the insolvent.

[82] *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931), 10 AFTR 458.

[83] § 270, Bankruptcy Act Title 11 U.S.C. § 670.

A radical change was made by the insolvency amendments in the application of Sections 268 and 270. Under amendments, if a plan of reorganization meets the requirements of Section 371 of the 1954 Code, there is no reduction in the basis of the assets in the hands of the reorganized corporation by reason of cancellation of debt under the plan, but that the basis of the assets is the same as the basis in the hands of the old company.[86] Insolvency reorganizations qualifying under Section 371 of the 1954 Code are no longer affected by Section 270.[87]

15. How to Preserve Carryover

New problems have been posed in insolvency reorganizations by the restoration of the net operating loss carryover and the enactment of the five-year capital loss carryover. Often, it is desirable to use a new corporate entity as the reorganized company because of obstacles in the corporate laws to the revamping of the capital structure of the debtor and for other reasons. If the debtor has substantial carryovers which would be available to it, as is often the case in insolvencies, this method may be very costly taxwise. Under a prior carryover provision, the Supreme Court held that only the "taxpayer"—not a corporation succeeding a predecessor corporation through reorganization—is entitled to the carryover loss deduction.[88] This decision stands as a warning despite a decision of the Court of Appeals for the Second Circuit which adopts a more realistic view and allows the deduction of a carryover to a technically new entity in a statutory consolidation, provided the consolidation continues the major business in which the losses carried over were incurred.[89]

The 1954 Code was designed to undo the earlier restrictive view and to allow a broader carryover of net operating losses, capital losses, amortization of bond discount, deficit in earnings and profits and other similar items in tax-free reorganizations and liquidations. The new provisions are, however, limited in the case of reorganization acquisitions to those that qualify under Section 368, the general reorganization provisions.[90] There is no provision as such granting to insolvency reorganizations the same benefits. It would, therefore, appear that a net operating loss carryover, for example, may be lost to a successor corporation in a reorganization tax-free under the insolvency provisions (Section 371), unless the transaction also qualifies under the general reorganization provisions. Because corporations in insolvency proceedings typically have suffered losses which may result in valuable carryover deductions, it may still be necessary, in order to preserve the net operating loss deduction, in cases where the general reorganization provisions cannot be satisfied, to preserve the corporate entity which incurred the loss in order to obtain future benefits from the carryover deduction. The same result may be obtained with respect to the other carryover provisions of the new Code. In short, the 1954 Code may have restricted the benefits of the insolvency provisions by the unduly restrictive application of Sections 381 and 382.

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[84] *Ibid.*

[85] See Stanley S. Surrey, "The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness," *Yale Law Journal*, 1940, Vol. 49, page 1153; Norris Darrell, "Discharge of Indebtedness and the Federal Income Tax," *Harvard Law Review*, April 1940, Vol. 53, page 977.

[86] IRC § 113(a)(22).

[87] See the Supreme Court's discussion of § 268 and § 270, in *Claridge Apartments Co.* v. *Commissioner*, 323 U.S. 141, 32 AFTR 1424 (1944); "Note, Debt Cancellation and Tax Basis Reduction in Chapter X Reorganization," *Yale Law Journal*, May 1947, Vol. 56, page 891.

[88] *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 13 AFTR 1180 (1934).

[89] *Stanton Brewery, Inc.* v. *Commissioner* (2 Cir. 1949), 176 F. 2d 573.

[90] 88 other requirements must also be met. They are set out in Section 381(a)(2).

16. Acceptance of the Plan by the Treasury

The Treasury has an additional hold on the estate in reorganizations under Chapter X. No plan of reorganization may be confirmed which provides for payment of less than the full amount of the taxes owed to the Treasury, unless the Secretary of the Treasury either accepts the plan, or fails to reject it, within 90 days after formal notice of the plan.[91] A provision may be made in the plan, of course, for the assumption by the reorganized or new corporation of all tax claims properly established.

The Treasury Department may object if the plan of reorganization appears to have as one of its primary purposes "the avoidance of taxes," and if the court finds that the objection is valid, the plan will not be approved.[92]

The Secretary of the Treasury has been given wide powers to accept less than the full amount of the taxes due, under Section 199 of the Bankruptcy Act. In a case in which the equities of the bankruptcy situation warrant, the trustee may be able to scale down tax claims which could not be defeated by the merits of the case. Similarly, experience under Section 199 indicates that the Treasury is not unsympathetic in lending a helping hand to insolvents in bankruptcy to get them back as going businesses and taxpayers.

17. Reorganizations and Stamp Taxes

New securities are normally issued to the security holders and new bonds are often issued to raise capital in reorganizations under Chapter X. There may be substantial stamp taxes on the transfer and issuance of stocks and bonds under such plans. Large blocks of real estate normally subject to stamp taxes may be conveyed.

The exchange, issuance, or transfer of securities, or the filing, making or delivery of conveyances to make effective a reorganization plan, confirmed in an equity receivership or bankruptcy proceeding, is exempt from all Federal stamp taxes.[93] All such transactions must occur within five years from the date of approval of the equity receivership, or the confirmation of the reorganization plan to come under the exemption.[94]

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[91] Bankruptcy Act § 199.

[92] Bankruptcy Act § 269.

[93] 1954 IRC § 4382(b).

[94] 1954 IRC § 4382(b). There is a somewhat similar provision in § 267 of the Bankruptcy Act, which applies to State as well as Federal stamp taxes. Unlike 4382(b) of the Code, § 267 does not contain the 5 year cut-off. However, when § 4382(b) then § 1808(e) of the 1939 Code was adopted in its present form, Congress specifically limited § 267 by § 1808(e); § 505(h)(4), Revenue Act of 1942; see Senate Finance Committee Report, 1942-2 C.B. 687.

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Farmer's Accounting

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For tax purposes, a farm is defined as embracing the word "farm" in its ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms; also plantations, ranches, and all land used for farming operations. All individuals, partnerships or corporations that cultivate, operate, or manage farms for gain or profit, as either owners or tenants, are designated as farmers. A person cultivating or operating a farm for recreation or pleasure, the result of which is a continual loss from year to year, is not regarded as a farmer for income tax purposes.[1]

This chapter considers the accounting problems of the farmer primarily in the light of the requirements of the income tax laws.

1. Points to Consider

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What accounting methods may farmers use? 2
How do farmers treat inventories? 3
What income must farmers report? 4
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2. Accounting Methods Available to Farmers

Farmers may use one of the three methods of reporting income for tax purposes shown in the table on page 345.

A farmer has the option of using either the cash or accrual basis of computing income, but, having elected one method, the option so exercised will be binding for subsequent years, unless permission to change accounting methods is granted by the Commissioner of Internal Revenue.

Cash basis. A farmer reporting his income on the cash receipts and disbursements basis must include in gross income for the year:

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[1] 1954 IRC § 61; 1939 IRC § 22(a), Reg. 118, § 39.22(a)-7.

Applicable Regulation	Method	Description
Regulations 118 Section 39.22(a)-7(a)	Cash basis	Income and deductions are accounted for when actually received or paid out.
Regulations 118 Section 39.22(a)-7(b)	Accrual basis	Income is reported when it becomes due, whether or not collected, and deductions are reported when the expenses are incurred, whether or not the bills have been paid.
Regulations 118 Section 39.23(a)-7(c)	Crop basis	The entire cost of producing the crop is taken as a deduction for the year in which the income from the crop is realized.

1. The amount of cash or the value of merchandise or other property received during the year from the sale of livestock and produce raised during the taxable or prior years,
2. The profits from the sale of any livestock or other items purchased, and
3. Gross income from all other sources.

No inventory is used in determining the gross income of a cash-basis farmer, but, in order to determine the gross income from the sale of livestock or other items purchased for resale, the farmer should keep a record of the individual costs of all such items.

Deductions for all except capitalizable items are taken for the year in which the expenditures are actually made.

Accrual basis. The gross profit of a farmer reporting income on the accrual basis is ascertained by adding:

1. The inventory value of livestock and produce on hand at the end of the year,
2. The amount received from the sale of livestock and produce,
3. Miscellaneous receipts for hire of teams, machinery, and the like, and deducting from this sum:

1. The inventory value of livestock and produce on hand at the beginning of the year, plus
2. The cost of livestock and produce purchased during the year.

Livestock acquired for draft, breeding, or dairy purposes, and not for resale, may be included in the inventory, instead of being treated as capital assets subject to depreciation, provided this practice is consistently followed.

Crop basis. The crop basis of reporting income is available only to farmers engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing. This method may be used only with the consent of the Commissioner.[2] Deductions for all expenses of producing the crop are taken in the year in which the income from the crop is realized.

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[2] Reg. 118, § 39.22(a)-7(c).

3. How Farmers Treat Inventories

Inventories under the accrual method of accounting are generally valued on the basis of either (1) cost or (2) cost or market, whichever is lower. Because of the difficulty of ascertaining actual cost of producing livestock and other farm products, however, an exception is permitted to those classed as farmers. A farmer may use either (1) the "farm-price method" or (2) the "unit-livestock-price method" of valuing inventories.[3] The inventory generally includes produce, livestock (raised or purchased for resale), feed, and like farm supplies that are held for sale or for current use. A farmer who uses the accrual method of accounting has the option of including or leaving out of the inventory livestock used for work, breeding, or dairy purposes. If not included in the inventory, the livestock must be capitalized and depreciated.[4]

Farm-price method. Under this method, the inventories are valued at market price less direct cost of disposition. The prevailing current bid price at the nearest market at the inventory date usually affords the best yardstick for determining the market price to be used. "Cost of disposition" includes the estimated cost of transporting the livestock or other products to market, plus commissions and other expenses of sale.

Unit-livestock-price method. This method provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. The classifications and the unit prices assigned to the several classes are subject to the approval of the Commissioner.[5] The unit prices should reasonably reflect the normal costs incurred in producing the animals within such classes. Once established, the unit prices and classifications must be consistently applied in all subsequent years, unless the Commissioner authorizes changes in such unit prices and/or classifications.

If the farmer elects to use the "unit-livestock-price method" he must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes. Livestock purchased for resale must be included in the inventory at cost. Animals purchased for breeding, dairy, or draft purposes may, at the election of the farmer, be included in the inventory or be treated as capital assets subject to depreciation.

4. What Farmers Report as Income

The farmer's income is computed in essentially the same manner as the income from any other business. Following are some of the items of income common to farmers:

a. Sale price of livestock, produce, etc.

b. Groceries, household goods, and other miscellaneous items received in exchange for livestock and farm products.

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[3] Reg. 118, § 39.22(c)-6(c).

[4] Reg. 118, § 39.22(a)-7(b).

[5] Reg. 118, § 39.22(c)-6(e).

c. Personal items or services received in exchange for livestock and farm products.

d. Breeding fees.

e. Compensation for the use of hired hands, farm teams, and machinery.

f. Farm rentals, including crop share rentals.

g. Crop damage payments and condemnation awards.

h. Benefit payments from federal, state, and local governments. If the farmer is on the cash basis, these payments are reported when checks are received; if he is on the accrual basis, payments are reported when they are officially authorized or when the allotment contract is accepted.[6]

i. Commodity Credit Corporation loans. Amounts received as loans from the Commodity Credit Corporation may, at the election of the farmer, be included in gross income for the taxable year in which received.[7] This permits the farmer to report income in the same year that the expenses are incurred. There might be no production expenses to deduct from income if the income is reported when the pledged commodities are sold. The election to treat the proceeds of Commodity Credit Corporation loans as income is binding for all subsequent years, unless the Commissioner authorizes a change.[8] When pledged property is sold, only the amount received in excess of the loan is considered to be income when received. If the proceeds from the sale are less than the amount of the loan, no loss may be taken if the farmer was relieved from liability for the deficiency.[9]

The value of farm products consumed by a farmer and his family need not be reported as income, but the costs of raising such products cannot be deducted as an income tax expense.[10]

Gains from the sale of livestock used for draft, breeding, or dairy purposes and from growing crops are discussed in Section 8 of this chapter.

5. What Deductions Farmers May Take

A farmer who operates a farm for profit, like any other business man, may deduct all of the ordinary and necessary expenses incurred in carrying on his business. Following are some of the typical expenses incurred by farmers:

a. Seed and fertilizer purchased. If the fertilizer is of the type that benefits the land for several years, its cost must be amortized over the period of its usefulness.[11]

b. Feed purchased, including grain, hay, silage, mill feeds, and roughage.

c. Machine hire for threshing, combining, silo filling, baling, ginning, and other purposes.

d. Veterinary fees.

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[6] I.T. 2767, XIII-1 C.B. 35; I.T. 2992, XV-2 C.B. 75; I.T. 3187, 1938-1 C.B. 159; I.T. 3379, 1940-1 C.B. 16.

[7] 1954 IRC § 77(a); 1939 IRC § 123(a).

[8] 1954 IRC § 77(b); 1939 IRC § 123(b).

[9] Reg. 118, § 39.123-2(2).

[10] T.D. 2665, March 8, 1918.

[11] I.T. 3843, 1947-1 C.B. 12.

e. Breeding fees.

f. Blacksmith and harness repairs.

g. Repairs and maintenance of capitalized improvements and equipment, such as barns, tanks, machinery, and other farm implements.

h. Depreciation.

i. Fuel and operating costs for automobiles, trucks, tractors, and machinery.

j. Farm labor, including cost of room and board furnished hired hands.

k. Cost of items sold, the sale price of which is reported as income.

l. Farm association membership fees.

m. Cost basis of livestock lost by death.

n. Cost of clearing underbrush and other forms of vegetation, in order to maintain pastures and fields in usable condition.[12]

o. Bad debts from sales that have been reported as income (not available to farmers using cash basis).

p. Insurance, interest, and taxes.

6. What Expenses and Losses of Farmers are Nondeductible

Farmers may not deduct expenses of a character that are not deductible in other businesses. Thus, a farmer may not take a deduction for:

a. Value of his own work and that of his family.

b. Value of raised farm products consumed by employees on the farm.

c. Cost of raising farm products for personal consumption.

d. Cost of machinery, equipment, automobiles, trucks, farm buildings, and other improvements and betterments.

e. Loss from shrinkage of stored farm products, unless the farmer is on the accrual basis and such losses are reflected through the inventory.

f. Value of growing crops lost through casualty, disease, or accident. Only the expenses for seed, fertilizer, and other costs incurred in raising the crop may be deducted.

g. Value of raised livestock lost through casualty, disease, or accident, unless the farmer is on the accrual basis, and then the loss is reflected through the inventory. A farmer on the cash basis may deduct the cost (not value) of purchased livestock lost.

h. Costs of maintaining and operating personal pleasure automobile.

i. Value of rent paid (crop share basis) in the form of crops raised, except to the extent of the actual costs of producing the crops.

If a farm is operated for recreation or pleasure,[13] or for the primary purpose of raising good food for personal consumption,[14] losses incurred in operating the farm are not deductible for income tax purposes. The farm must be operated with the intent of making a profit. The actual expectation of making a profit is the controlling factor.[15] The proper test is not the reasonableness of the belief or expectation that a profit will be realized, but whether the farming operations are entered into and carried on in good faith for the purpose of making a profit, or in the belief that a profit can be realized thereon.[16] The various courts have repeatedly held that the fact that continuous losses have been incurred does not alone establish that a farm was not operated for profit.[17] This rule is apparently observed without regard to the number of years in which continuous losses have been sustained.[18] The courts have applied a multitude of tests for the purpose of determining whether or not farms were operated with the expectation of making a profit, but a detailed discussion of this subject is without the scope of this chapter.

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[12] Costs of preparatory clearing must be capitalized. *J. H. Sanford*, 2 B.T.A. 181 (1925).

[13] Reg. 118, § 39.23(a)(11).

[14] *Louise Cheney*, 22 B.T.A. 672 (1931).

[15] *Thacher* v. *Lowe* (D.C., S.D. New York 1922) 288 F. 994, 2 AFTR 1931; *Farish* v. *Commissioner* (5 Cir. 1939), 103 F. 2d 63, 22 AFTR 1009; *Tatt* v. *Commissioner* (5 Cir. 1948), 166 F. 2d 697, 36 AFTR 834; G.C.M. 21103, 1939-1 C.B. 164.

7. How Farmers Treat Preparatory and Development Expenses

A farmer is given the option of treating as investments of capital amounts expended in the development of farms, orchards, and ranches, prior to the time when the productive state is reached.[19] This option covers only expenditures incurred during the *period of development* which might otherwise be deductible as current expenses; it does not permit capital items to be treated as ordinary and necessary business expenses.[20] Any money expended during the *preparatory period* must be capitalized. Typical items which are required to be capitalized, and to which the option does not apply, are preparatory costs of:

a. Clearing brush, trees, and stumps.
b. Leveling and conditioning of land.
c. Planting trees.
d. Drilling and equipping wells.
e. Building irrigation canals and ditches.
f. Laying irrigation pipes.
g. Installing pipes or drain tile to prevent erosion.
h. Constructing earthen, masonry, or concrete tanks, reservoirs, or dams.
i. Building roads.
j. Any equipment having a useful life of more than one year.

The option applies to expenses incurred during the development period for:

a. Upkeep of the grove or orchard.
b. Taxes.
c. Water for irrigation purposes.
d. Cultivating and the spraying of trees.

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[16] *Cecil* v. *Commissioner* (4 Cir. 1939), 100 F. 2d 896, 22 AFTR 344; *David McMorran*, par. 39,117 Prentice-Hall Memorandum B.T.A. (1939); *Henry M. Curry*, par. 39,090 Prentice-Hall Memorandum B.T.A. (1939).

[17] *Samuel Riker, Jr., Executor*, 6 B.T.A. 890 (1927); *Rose P. Crane, Executrix*, 9 B.T.A. 97 (1928); *Marshall Field*, 26 B.T.A. 116 (1932) *affirmed*, (2 Cir. 1933), 67 F. 2d 876, 13 AFTR 415; *Norton L. Smith*, 9 T.C. 1150 (1947).

[18] In *Shadybrook Farm, Inc.*, par. 42,114 Prentice-Hall Memorandum B.T.A., deduction was allowed despite the fact that the farm had been operated at a loss for 30 consecutive years. The overall limitation of Code section 270 (prior section 130(a)) is applicable to losses from farming.

[19] Reg. 118, Sec. 39.23(a)(11).

[20] Mim. 6030, 1946-2 C.B. 45; Thompson and Fogler Co., 17 T.C. 722 (1952).

e. Commercial fertilizers that must be renewed from year to year because their benefit is of short duration.

The option to capitalize current expenses during the development period, prior to the time when the productive state is reached, may serve as an income tax benefit in cases where no income will be realized from the farming operations for a number of years after commencement of operations. This option was granted by the Commissioner as an aid to farmers who might have no income to offset expenses incurred during the development period.

Care should be taken to distinguish between *preparatory expenditures* and *operating expenses*. In a recent case[21] the Commissioner contended that the cost of grading of the land into earthen terraces should be capitalized. The Tax Court, in holding that the cost of the terracing was deductible as an operating expense, pointed out that nothing was added to the soil; no new farming areas were developed; and no clearing of the land or work to prepare the land for cultivation was done. Further, the terracing work did not change the fertility of the soil; it did not make farming operations easier; and it did not increase the value of the land or its products. The expenditures were considered to be in the nature of repairing land which was eroded so as to maintain it in a way which would be as nearly free from defects caused by erosion as possible. So viewed, the cost of terracing was deductible as an ordinary and necessary business expense under Section 162 of the Internal Revenue Code of 1954.

8. Capital Gains and Losses of Farmers

The general provisions of Code sections 1221 and 1222 (prior Code section 117), relating to capital gains and losses, affect the farmer just as they do any other business man. The principal controversy between the farmer and the Commissioner of Internal Revenue arose almost immediately after subsection (j) was added to section 117 of the prior Code (now Section 1231) by the Revenue Act of 1942. Prior to that time, property, used in a trade or business, of a character subject to the allowance for depreciation, was excluded from the category of capital assets. When the addition of Code section 1231 (prior Code section 117(j) allowed capital gains treatment on the gain realized from the sale or exchange of property used in a trade or business, of a character subject to the allowance for depreciation (excluding property of a kind properly includible in the inventory if on hand at the close of the taxable year, and property held primarily for sale to customers in the ordinary course of a trade or business), held for more than 6 months, the farmer recognized that his draft, breeding, and dairy herds were property used in his trade or business, of a character subject to the allowance for depreciation.

Apparently, the *Stutzman* case[22] was the first case that allowed a farmer capital gains treatment on the sale of his dairy and/or breeding herd, although the *Albright* case[23] is generally credited with this distinction. After a long period of judicial controversy, a detailed discussion of which is not within the scope of this chapter, involving principally the question of whether livestock sold constituted property "held primarily for sale to customers in the ordinary course of his trade or business," [24] Congress, by Sec. 324 of the Revenue Act of 1951, amended section 117(j) of the 1939 Code (now Section 1231) by adding at the end thereof the following new sentences: "Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry." The amendment was made applicable to the years beginning after December 31, 1941, except that the extension of the holding period from 6 months to 12 months was made applicable only to the years beginning after December 31, 1950.

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[21] *J. H. Collingwood,* 20 T.C. 837 (1953) (acq.).

[22] *Stutzman* v. *U.S.* (D.C., N.D. Indiana), 72 F. Supp. 879, 35 AFTR 1667.

[23] *Albright* v. *U.S.* (8 Cir. 1949), 173 F. 2d 339, 37 AFTR 1125.

As evidenced by the Committee reports, it was the intent of Congress to clarify the capital gains law as it affected the sale of livestock. It is apparent, however, that the courts view the 1951 amendment as having accomplished little toward determining what livestock should be considered to comprise the draft, breeding, or dairy herds. In a case decided since the 1951 amendment,[25] the United States Court of Appeals for the Tenth Circuit has ruled that "The important thing is not the age of the animals, but the purpose for which they are held." Some tax counsel interpret this case as authority for the position that the 1951 amendment accomplished nothing except to extend the holding period from 6 months to 12 months and to eliminate poultry from the definition of property used in the trade or business. It is obvious that the end of litigation on this subject is not yet in sight.

The Regulations on this section[26] provide that the determination of whether or not livestock is held by the taxpayer for a draft, breeding, or dairy purpose depends upon all of the facts and circumstances in each particular case, and that the purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal. An animal may be considered as held for a draft, breeding, or dairy purpose, even though it is never actually used for such purpose, if the animal is disposed of within a reasonable time after its intended use for such purpose is prevented by accident, disease, or other circumstance; but an animal will not be considered to be held for a draft, breeding, or dairy purpose merely because it is suitable for such purpose or because it is held for sale to other persons for use by them for such purpose. An animal held for other purposes will not be considered to be held for a draft, breeding, or dairy purpose merely because of a negligible use of the animal for such purpose or because of the use of such animal for such purpose as an ordinary incident to the purpose for which the animal is held.

If a farmer sells standing timber which he has owned for not more than 6 months, the gain is taxable as ordinary income. If the timber is cut at a time when it has been owned for less than 6 months and is later sold in the form of logs, pulpwood, or firewood, the gain is taxable as ordinary income, even though the sale is consummated more than 6 months after the date the timber was acquired. If a farmer sells standing timber, not held primarily for sale to customers in the ordinary course of his business, which he has owned for more than 6 months, the gain is treated as a long-term capital gain.

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[24] The Senate Finance Committee described the problem in these words: "In the case of farmers there has been considerable confusion and dispute for several years as to whether all livestock held for draft, dairy, or breeding purposes is 'property used in the trade or business' or whether in some cases the livestock should be deemed held 'primarily for sale to customers in the ordinary course of his trade or business.'"

[25] *Fox* v. *Commissioner* (4 Cir. 1952), 198 F. 2d 719, 42 AFTR 544.

[26] Reg. 118, Sec. 39.117(j)-2.

A farmer who has owned, or who has held a contract right to cut, timber for a period of more than 6 months before the beginning of the taxable year has an optional election under Code section 631(a) (prior Code section 117(k)(1)) to consider the cutting of such timber during such year for sale or for use in his trade or business as a sale or exchange of the timber so cut.[27] If the election is made, gain or loss will be recognized in an amount equal to the difference between the adjusted basis of the timber in the hands of the farmer and the fair market value of such timber as of the first day of the taxable year in which the timber is cut. The market value of the timber as of the beginning of the year then becomes the basis for computing the gain on the actual sale of the logs, pulpwood, or other products.

If a farmer makes an election under Code section 631(a) (prior section 117(k)(1)), such election shall apply with respect to all timber owned by the farmer, or which he has a contract right to cut, and shall be binding for the taxable year and all subsequent years, unless the Commissioner, on showing of undue hardship, permits a revocation of the election.

The application of Code section 1231 (prior section 117(j)) to the sale of growing crops gave rise to about as much difference of opinion as the application of the section to the sale of livestock. In the Revenue Act of 1951, Congress sought to resolve this question by the addition of subparagraph 117(j)(3) to the 1939 Internal Revenue Code, which specifically provides that in the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and land are sold, exchanged, or compulsorily or involuntarily converted, at the same time and to the same person, the crop shall be considered as "property used in the trade or business." The Commissioner was successful in getting Congress to enact Code section 268 (prior section 24(f)), which provides that in the sale of such an unharvested crop, in computing the net income, no deduction attributable to the production of such crop shall be allowed. Under the provisions of Code section 1016 (prior section 113(b)(1)), the cost of producing the crop will be treated as an addition to the adjusted basis of the property sold. In other words, the farmer gets long-term capital gain treatment on the gain from the sale of his unharvested crop, but the cost of producing the crop is treated as a capitalizable expenditure.

9. Accounting Records of Farmers

Many farmers have been informed that they are not required to maintain accounting records for income tax purposes. The wording of the Regulations is partly responsible for this erroneous belief.[28] A memorandum decision of the Tax Court, however, points up the risks that a farmer incurs when he fails to keep permanent records or books of account.[29] In that case, the examining revenue agent had made adjustments with which the taxpayer farmer took issue. The Commissioner's adjustments were approved, because the farmer had failed to keep adequate books and records which might have overcome the presumption of the correctness of the Commissioner's findings.

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[27] Reg. 118, Sec. 39.117(k)-1.

[28] Reg. 118, Sec. 39.33(a)-7(e), for example, provides: "Form 1040F should be filled in and attached to his income tax return by every farmer who either keeps no records or only records of cash receipts and disbursements; its use is optional with other farmers." Reg. 118, Sec. 39.54-1 states, in part: "Records and income tax forms. (a) Every person subject to the tax, except persons whose gross income . . . (2) arises solely from the business of growing and selling products of the soil, shall, for the purpose of enabling the Commissioner to determine the correct amount of income subject to the tax, keep such permanent books of account or

The Commissioner has been aware of the fact that most farmers are lax with their record keeping, and for this reason he has attempted to provide a method for reporting farmers' income that will help them eliminate many of the mistakes that might otherwise be made. In recent years, since the personal tax exemptions have been lowered and farmers' incomes have been higher on the average, many farmers who were never before required to file income tax returns have found it necessary to file returns. There can be no argument that the proper figures to be used on the tax return are the figures that reflect the farmer's true income and expenses, and that the best place for keeping these figures is in some kind of set of accounting records.

It is safe to say that most farmers employ a single entry form of maintaining their accounting records. Many farmers who have sought professional accounting aid, however, have been surprised to learn that with very little instruction, they can be taught to keep a double entry set of accounting records that requires less time and furnishes a great deal more information than a single entry form. The double entry form of accounting is especially helpful in accounting for the cost and date of acquisition of fixed assets and their related depreciation reserves. The accounting records of a cash basis taxpayer are just as important as the records of an accrual basis taxpayer.

Aside from the accounting records, a farmer's tax case may be materially helped, in the event of sales from his breeding herd, if the farmer maintains records on all cattle suitable for breeding purposes, setting forth their registration numbers, if any, their ages, production records, and other pertinent information. Even since the Revenue Act of 1951, the farmer still has the burden of proof of his purpose, and he must be prepared to prove that the animals were not held primarily for sale to customers in the ordinary course of business.

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records, including inventories, as are sufficient to establish the amount of the gross income and the deductions, credits, and other matters required to be shown in any return under chapter 1. . . ."

[29] *W. Sam Hendricks*, par. 49,190 Prentice-Hall Memorandum T.C. (1949). Following is a pertinent excerpt from the Court's opinion:

"Petitioner relies heavily upon section 29.54-1 of Regulations 111. That regulation obviously merely releases the farmer from the obligation of maintaining customary account books, including inventories, etc., such as would be maintained by a taxpayer engaged in manufacturing or trade. However, the regulations pertaining to income of farmers obviously requires that reasonably accurate accounts shall be kept. Section 29.22(a)-7 provides that the farmer in making his reports shall include the amount in cash or value of all sales of livestock and produce, the profits therefrom, and the gross income from all other sources. It specifies that the profits shall be determined by deducting the cost price from the sale price, less depreciation under certain circumstances. Section 29.41-1 provides that if the farmer's method of 'accounting' clearly reflects his income, it is to be followed but that if that method of accounting does not reflect the income, the Commissioner shall prescribe the method of accounting to be used. The regulations do not relieve the farmer, when his income tax return is examined and adjustments recommended, from furnishing sufficient data to enable the Commissioner and the Tax Court to determine the taxpayer's taxable income with reasonable certainty."

10. What Changes Were Made by the Internal Revenue Code of 1954

The Internal Revenue Code of 1954 by and large left the farmer as such in the same position for federal tax purposes as under the 1939 Code. There is one important exception: All expenditures paid or incurred for the prevention of the erosion of land used in farming as well as expenditures for soil and water conservation with respect to land used in farming are deductible, at the farmer's election, as ordinary and necessary business expenses.[30] The farmer is no longer required to treat such expenses as nondeductible capital expenditures.

Deductible expenses include those costs "paid or incurred" for leveling, grading, terracing, contour furrowing, construction, control and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets and ponds, eradication of brush, the planting of windbreaks, and other treatment and moving of the earth.[31]

The Senate Finance Committee report explicitly states that this deduction is not allowable for expenditures relating to depreciable structures or facilities, made of concrete, metal and the like, or for any expenses which are deductible under some other section of the Code.[32]

Special assessments, such as a levy by a soil and water conservation district, may also be an allowable deduction. That much of the levy is deductible which, if paid or incurred by the farmer himself, would be deductible under this Code section but not deductible under any other section of the Code.

The application of this rule is illustrated by the Senate Finance Committee by the following example in its report. A soil and water conservation district levies an assessment against a farmer. The levy is allocable as follows: $500 for digging of natural drainage ditches, $250 for maintenance and interest charges, and $250 for purchase of depreciable assets. The farmer may only deduct the $500 under Code section 175. The $250 for maintenance and interest charges is deductible under another provision of the Code. The $250 for depreciable assets is not a deductible expense.[33]

The farmers' deductions in any one taxable year for soil and water conservation expenses are limited in amount to 25 per cent of the gross income derived from farm operations during that year. Any excess amounts may be deducted in succeeding years subject to the 25 per cent limitation for any one year. These excess amounts may be carried forward from year to year until used up, without any limitation as to time but within the over-all 25 per cent limitation of deductible amounts.[34]

For the first taxable year beginning after 1953, the farmer may elect this method for deduction of soil and water conservation expenses without the consent of the Commissioner. Thereafter, he may adopt this method of treatment at any time with the consent of the Commissioner. Once having made his election, the farmer may not change without the consent of the Commissioner.[35]

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[30] 1954 IRC § 175; no equivalent provision in the 1939 Code.

[31] Sen. Rep. No. 1622, 83rd Cong., 2nd Sess., 217 (1954).

[32] *Ibid.*

[33] *Ibid.*; 1954 IRC § 164(b)(5); 1939 IRC § 23(c)(1).

[34] Sen. Rep. No. 1622, 83rd Cong., 2nd Sess., 218 (1954).

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[35] *Ibid.*

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Oil and Gas Producers' Accounting

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Oil and gas producers' accounting is perhaps influenced to a greater degree by the Federal income tax laws than the accounting of any other industry. In many industries the net income for Federal income tax purposes very closely coincides with the net income computed by applying generally accepted accounting principles, uninfluenced by the income tax laws. The same is by no means true, however, in the oil and gas producing industry. Because every oil and gas producer desires to keep his income tax liability at a legal minimum, and because this income tax liability must be determined from the accounting records as maintained, the discussion in this chapter is directed primarily toward accounting techniques that serve the best interests of the oil and gas producer for income tax purposes.

Of special importance are the income tax provisions relating to intangible drilling and development costs, the depletion allowance, and the realization of gain or loss upon the sale or exchange of properties. The Internal Revenue Code of 1954 has effected a number of income tax changes applicable to the oil and gas producing industry, some of which help to simplify accounting procedures. The complex nature of oil and gas operations and the income tax laws relating to such operations make it imperative that the oil operator avail himself of skilled accounting and legal services.

The term "oil operator," as herein used (except where specifically noted), whether referring to an individual, partnership, or corporation, means one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights.[1]

1. Points to Consider

The accounting problems of the oil and gas producer are considered under the following headings:

	Section
Types of interests in oil and gas properties	2
Accounting for intangible drilling and development costs	3

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[1] Reg. 118, § 39.23(m)-16(1).

Section
Accounting for the depletion deduction 4
Accounting for the proceeds realized from the sale or exchange of oil properties 5
Agreements by which oil and gas producers may develop properties without using personal funds 6
Accounting for joint operations of oil and gas leases 7
Miscellaneous changes under the Internal Revenue Code of 1954 8

2. Types of Interests in Oil and Gas Properties

Interests that may be encountered in oil and gas properties are commonly referred to in the field of taxation as "economic interests." This term denotes ownership of oil and gas in place or the possibility of income dependent solely upon the extraction and sale of the oil and gas. The ownership of an "economic interest" is a prerequisite for the allowance of the depletion deduction. A brief description of these interests is outlined below:

Working interest. The working interest is the interest owned by the lessee or sublessee under an oil and gas lease and usually entitles the lessee or sublessee to receive seven-eighths of the gross production from the property. This interest bears all costs of exploration, development, and operation, including its pro rata share of the gross production taxes.

Royalty interest. The royalty interest is that part of the production retained by the lessor and usually comprises one-eighth of the oil and gas produced from leased property, although this is a matter to be determined by the lease contract, and the fractional interest may be more or less. It is not unusual for the owner of the surface rights to own only a fractional part, or even none, of the mineral rights, since the surface and mineral rights may constitute separate property interests in the fee and be independently conveyed. The royalty interest bears no part of the development or operating expenses, except its pro rata share of the gross production taxes.

Royalty interests may be perpetual or limited in length of life. A perpetual royalty interest is one in which ownership is not affected by the passing of time. A limited royalty interest, usually called a "term royalty," passes to a buyer when the owner of a mineral interest sells all or a portion of the royalty for a specified length of time. If oil or gas is found on the property within the specified period, the buyer's interest is perpetuated as long as oil or gas is being produced from the property. Should there be no production during the specified period, however, the royalty interest reverts to the original owner. In addition to being limited in length of life, royalty interests may also be limited as to the amount of income which might be received from production.

Royalty interests may be either participating or nonparticipating. The owner of a participating royalty interest has an interest in any bonuses that may be received for a lease on the property and a right to a portion of any delay rentals. A nonparticipating royalty owner receives only a portion of the oil or gas, if, as, and when produced. Usually when the owner of a participating royalty interest does not own the land, it is referred to as a mineral interest.

Overriding royalty interest. An overriding royalty interest is usually carved out of the working interest, and it ordinarily arises when the original lessee subleases the property and retains a fractional interest in production. The overriding royalty, like the regular royalty, bears no portion of the development or operating costs, except its pro rata share of the gross production taxes, and it may be limited either in length of life or amount of income from production.

The proceeds from oil and gas production payable to the owner of a royalty are not considered rent; such payments are considered to be the owner's pro rata share of the proceeds from the extraction and sale of the oil and gas in place.[2]

Oil and gas production payments. Oil and gas production payments are limited interests in the production and are usually carved out of the working interest. They differ from royalty interests in that they entitle the owner to oil or gas produced, or the proceeds derived from an agreed share of production, until a fixed or determinable amount of oil or gas, or an ascertainable sum of money, has been received.[3]

For Federal income tax purposes, it is necessary that the oil and gas payment be payable only out of the proceeds of oil and/or gas if, as, and when produced; otherwise, the term "oil and gas payment" has no significance, and payments to the oil and gas payment holders are not excluded from the operator's gross income.[4] The oil and gas payment may become payable upon the first production from a leasehold, or it may not become payable until the operator of the property has recovered a specified sum from production.[5] It may also be paid from a specified percentage of the oil and gas produced, after deducting a pro rata share of the expenses of production.[6] From a practical standpoint, these two latter types of oil and gas payments are exceptions rather than the rule.

Carried interest. A carried interest arrangement is unique within the oil and gas industry. It permits the owner of a working interest to have his interest in the leasehold developed without an outlay of his own cash funds. A "carried interest" arises where one co-owner of the working interest agrees to pay all of the development and operating costs and to recoup the other party's share of such costs from his share of the oil and gas, if, as, and when produced. The party financing the operations is referred to as the "carrying party" and the other party is referred to as the "carried party." There is no personal obligation on the part of the carried party to reimburse the carrying party.

A carried interest may last for the entire life of the lease, or it may last only for a limited time. Carried interests may be classified as the "reversionary type" or the "co-ownership type." Under the reversionary type of carried interest, the carried party assigns the legal title to all of the working interest to the carrying party, with the stipulation that title to the carried party's fractional share of the working interest will revert to him at the end of a defined "payout" period. Under the co-ownership type of carried interest, the carried party retains legal title to the fractional share of the working interest but assigns all of the income from production to the carrying party during the payout period.

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[2] G.C.M. 22730, 1941-1 C.B. 214.

[3] G.C.M. 24849, 1946-1 C.B. 66.

[4] See *Anderson* v. *Helvering,* 310 U.S. 404, 24 AFTR 967 (1940). *T. W. Lee,* 42 B.T.A. 1217 (1940), contains an excellent definition of an oil and gas payment recognized for Federal income tax purposes.

[5] *Jones* v. *Commissioner* (5 Cir. 1936), 82 F. 2d 329, 17 AFTR 633.

[6] *Commissioner* v. *Caldwell Oil Corporation* (5 Cir. 1944), 141 F. 2d 599, 32 AFTR 434.

As between the parties, the two types of carried interests accomplish the same results; but for Federal income tax purposes, the courts have apparently made a distinction. In the reversionary type of carried interest, the carrying party is considered, as sole owner of the lease, to be the only operator. As such, he is taxed on all of the income and is entitled to deduction for all expenditures from the lease during the payout period.[7] Under the co-ownership type of carried interest, the courts, in the *McMurray* and *Abercrombie* cases,[8] have considered that the carried party is taxable on his share of the income, and it follows that only the carried party is entitled to deduction for his share of the intangible and operating costs during the payout period.

The Commissioner has voiced his dissent to the *McMurray* decision[9] but has withdrawn, without comment, his non-acquiescence to the *Abercrombie* decision.[10] The withdrawal by the Commissioner of his non-acquiescence to the *Abercrombie* decision apparently placed him in an inconsistent position with that taken in G.C.M. 22730. Unofficially, it is believed that the Commissioner will follow the *Abercrombie* decision only in cases where the facts are on all fours. It is generally believed that if an assignment is drawn in such a way as clearly to establish a carried interest of the reversionary type, the Commissioner will allow the deductions to the carrying party and will not charge the carried party with income during the payout period.[11] Until the Commissioner announces a clear-out position with respect to carried interests, however, taxpayers who execute carried interest arrangements today do so at their own risk,[12] unless direct tax rulings can be obtained for the particular transactions.

Net profits agreement. A net profits agreement is a contract under which the beneficiary is to be paid a percentage of the profits (as may be defined by the contracting parties) from the operation of oil and gas producing property. The operator pays all costs of development and operation, and the holder of the net profits interest receives income only out of the net profits resulting from production. These interests are usually acquired either through retention by a lessor in making a lease or by a sublessor in making a sublease.[13]

The Supreme Court of the United States has held that a share of the net profits acquired by either of the above-mentioned methods is in substance a royalty, the income from such net profits interests being subject to the depletion deduction in the hands of the owners and excludable from gross income by the operators.[14] It has been argued that the recipient of the net profits payments should be permitted to compute statutory depletion upon his contract percentage of the gross receipts from oil and gas. Such theory has been rejected,[15] the court holding that the cash payments made under the net profits agreement are the measure of gross income for the purpose of computing the depletion deduction.

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[7] *Manahan Oil Co.*, 8 T.C. 1159 (1947).

[8] *Reynolds* v. *McMurray* (10 Cir. 1932), 60 F. 2d 843, 11 AFTR 840, cert. den. *McMurray* v. *Reynolds*, 287 U.S. 644 (1932); *Commissioner* v. *Abercrombie* (5 Cir. 1947), 162 F. 2d 338; 35 AFTR 1467.

[9] G.C.M. 22730, 1941-1 C.B. 214, at page 224.

[10] 1949-1 C.B. 1.

[11] For a discussion on this subject, see J. Paul Jackson, "Tax Planning Before Drilling: The Operator's Problem," 1952 *Tulane Tax Institute*, 175, at pages 196, 197.

[12] See I-3 *Oil and Gas Tax Quarterly*, at page 13, for discussion.

[13] In *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599 (1946), 34 AFTR 526, a land owner retained a share of the net profits from operations. In *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25 (1946), 34 AFTR 1017, a lessee retained a share of the net profits upon assignment of a lease.

The Board of Tax Appeals has held that payments to a geologist, under an agreement whereby the operator was to pay the geologist a salary and expenses plus a share of the net profits from the properties acquired as a result of the efforts of the geologist, were capital expenditures of the operator, recoverable through depletion as a part of the cost of the properties.[16] Under present-day thinking, the geologist would probably be considered as owning an economic interest, and this early decision would not be followed.[17]

The popularity of net profits agreements increased after the withdrawal by the Commissioner of his non-acquiescence in the *Abercrombie* case. From the standpoint of the carried party, he enjoys substantially every benefit under the net profits arrangement that he enjoys under the carried interest arrangement. Under either arrangement, the carrying party finances all development and operating costs during the payout period (under the net profits arrangement he continues the financing throughout the life of the lease), and the carried party shares in the proceeds from production only after the end of the payout period. The principal disadvantage of the net profits arrangement, from the standpoint of the carried party, is that under the net profits arrangement the measure of gross income for the purpose of computing the statutory depletion deduction is the share of the net profits that he receives, whereas, under the carried interest arrangement, his gross income for the purpose of computing the depletion deduction is the total income from production of his fractional share of the working interest. This disadvantage may be offset by the limitation of the carried party's liability, under the net profits arrangement, for sharing in all of the expenses of development and operations after the payout period.

No attempt is herein made to rationalize the decisions holding that a share of the net profits is non-depletable income and those holding that it is depletable income.[18] It is now generally believed that the Commissioner will make no distinction between a case where the owner of a net profits interest acquired it by retention and a case where he was a stranger to the property. In either event he will probably be considered to be the owner of an economic interest, subject to the depletion deduction.

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[14] *Kirby Petroleum Co.* v. *Commissioner* and *Burton-Sutton Oil Co.* v. *Commissioner,* footnote 13, above.

[15] *Felix Oil Co.* v. *Commissioner* (9 Cir. 1944), 144 F. 2d 276, 32 AFTR 1186.

[16] *Schermerhorn Oil Corporation,* 46 B.T.A. 1511 (1942).

[17] Reg. 118, § 39.23(m)-1(b) provides that an economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place and secures, by any form of legal relationship, income derived from the severance and sale of the mineral, to which he must look for a return of his capital. See also "Assignment of an Economic Interest for Personal Services," I-4 *Oil and Gas Tax Quarterly,* page 18.

[18] Cf. *Helvering* v. *O'Donnell,* 303 U.S. 370 (1938), 20 AFTR 785; *Helvering* v. *Elbe Oil Land Development Company,* 303 U.S. 372 (1938), 20 AFTR 787; *Kirby Petroleum Co.* v. *Commissioner* and *Burton-Sutton Oil Co.* v. *Commissioner,* footnote 13, above.

3. Accounting for Intangible Drilling and Development Costs

Regulations issued by the Commissioner of Internal Revenue permit optional treatment of expenditures in connection with the development of oil and gas properties.[19] For Federal income tax purposes, an operator is permitted either to capitalize or to charge to expense certain development costs. These items are termed "intangible drilling and development costs." If a taxpayer makes election to expense the intangible costs, they may be treated as expenses for Federal income tax purposes, even though they are capitalized on the accounting records. While the Commissioner's Regulations have apparently had legislative sanction since 1945,[20] the Internal Revenue Code of 1954 for the first time by statutory provision directs the Secretary to prescribe regulations granting an oil and gas producer the right to deduct as expenses intangible drilling and development costs.[21]

Examples of items to which the option applies are amounts paid for labor, fuel, repairs, hauling, supplies, and the like, which are used (a) in the drilling, shooting, and cleaning of wells; (b) in such clearing of ground, draining, road making, surveying, and geological work as are necessary in preparation for the drilling of wells; and (c) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. In general, this option applies only to those drilling and development items which, in themselves, do not have a salvage value. The above-mentioned items are not considered to have a salvage value, even though used in connection with the installation of physical properties that do have a salvage value.

A guide to the classification of expenditures as capital or expense is presented in Mim. 6754.[22] Expenditures incurred in installing production facilities, such as pumps, pipe lines, and tank batteries, are excluded from the option. A producing well is considered by the Commissioner to be completed when the casing, including the "Christmas tree," has been installed. The cost of casing, even though it is cemented in the well to such an extent that it cannot be salvaged, must be capitalized. Geological expenses incurred in locating a well site fall within the option,[23] but where geological and geophysical expenditures result in the acquisition or retention of leases, such expenditures must be capitalized as leasehold costs.[24]

The option applies to all costs of drilling and development undertaken (directly or through a contract) by an operator of an oil and gas property, whether incurred by him prior or subsequent to the formal grant or assignment to him of operating rights. In a case where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, however, only that part of the cost thereof which is attributable to such fractional interest is within the option.[25] A taxpayer may deduct intangible expenses incurred by him only to the extent that such expenses are applicable to the fractional working interest that he owns. The expenses must actually be *incurred* by the taxpayer who claims the deduction.[26]

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[19] Reg. 118, § 39.23(m)-16.

[20] See House Concurrent Resolution 50, Seventy-ninth Congress, July 21, 1945.

[21] 1954 IRC § 263(c).

[22] Mim. 6754, 1952-1 C.B. 30.

[23] Reg. 118, § 39.23(m)-16(a)(1).

[24] *Louisiana Land and Exploration Company*, 7 T.C. 507 (1946); I.T. 4006, 1950-1 C.B. 48.

In connection with this optional treatment of expenditures, it should be noted that the owner of a working interest would seldom benefit by electing to capitalize such expenditures. This is true because, if an election is made to expense the intangibles, the taxpayer gets a 100 per cent deduction for the expenses for the year in which they are incurred, and he is still allowed to take the statutory depletion deduction in subsequent years of production. In the days when operating losses could not be carried backward or forward, of course, it often worked to the advantage of the taxpayer to elect to capitalize intangible costs and recover them through depletion. If an operator has elected to capitalize intangible drilling costs, he is accorded an additional option of deducting as an ordinary loss or capitalizing the cost of drilling a non-productive well.[27] It should be remembered that once an election is exercised, a taxpayer must follow this election consistently in all future years, unless the law or the Regulations are changed, thereby giving him the right to exercise a new option.

Prior to January 1, 1943, the option did not apply to so-called "turnkey" contracts for drilling of wells. Turnkey contracts, in the case of oil and gas wells, are contracts to drill wells to an agreed depth or depths and furnish all of the equipment necessary for completing the wells ready to be turned into the flow lines. The Regulations now allow an allocation of the total consideration between the physical property and intangible drilling and development costs. If the actual costs of installation of the physical depreciable property can be determined, the remainder of the cost may be allocated to intangible costs. Any equitable apportionment should meet the approval of the Commissioner.

As an aid to the interpretation of financial statements or annual reports, if the oil and gas producer capitalizes intangible drilling and development costs for accounting purposes but elects to expense such costs for Federal income tax purposes, it may be necessary to make disclosure of this practice in any case where yearly expenditures fluctuate so widely as to distort results of operations when comparing one year with another. Capitalized intangible drilling and development costs should be amortized over the productive life of the lease, preferably on a unit of production basis.

Thus far the term "operator" has been used in the sense that it is defined in the Regulations, to denote one who owns a working interest or other form of operating right. It is not unusual for several parties to own fractional working interests in the same oil and gas lease; hence, in the sense that the term "operator" has been used, there may be more than one operator of a lease. In a more technical sense, the term "operator" is used in the oil and gas producing industry to denote one who conducts the actual development and operation of the lease under an operating agreement. In many cases the operator pays all costs of development and operating expenses and periodically bills the other co-owners for their respective shares of such costs.

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[25] Reg. 118 § 39.23(m)-16(a)(1).

[26] *Sidney Platt*, 18 T.C. 1229 (1952).

[27] Reg. 118 § 39.23(m)-16(b)(4).

In a recent case, the Tax Court had for consideration the question of whether a cash basis taxpayer should deduct his share of the intangible development costs in the year in which they were paid by the operator or the year in which the taxpayer personally reimbursed the operator.[28] The Tax Court held that when the operator made expenditures on behalf of the co-owner taxpayer, the operator in effect made a loan to the taxpayer, and the expenses were properly deductible by the cash basis taxpayer in the year in which they were actually paid by the operator. The decision of the Tax Court was sustained by the United States Court of Appeals for the Fifth Circuit,[29] which rejected the taxpayer's theory that when the operator paid the expenses for the co-owner taxpayer, the operator was merely subrogated to the position of the creditor.

4. Accounting for the Depletion Deduction

The allowable depletion deduction for each separate property must be computed for each taxable period by using either (a) the cost or (b) the percentage of income method, whichever produces the greater deduction. The term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate parcel of land.[30]

If an oil and gas producer owns two or more separate operating mineral interests (whether or not they are included in a separate tract or parcel of land and whether or not they are included in contiguous tracts or parcels) which constitute part or all of an operating unit, he may elect, for the purpose of computing the allowable depletion deduction, to form one aggregation of, and to treat as one property, any two or more of such interests, and to treat as a separate property each interest which he does not elect to include in the aggregation. Not more than one aggregation of mineral interests can be formed out of the same operating unit. If a taxpayer owns two or more non-operating interests (interests in respect of which costs of production are not required to be taken into account in computing percentage depletion) in a single tract or parcel of land or in two or more contiguous tracts or parcels of land, he may be permitted, upon the showing of undue hardship, to treat such interests as one property.[31]

Cost depletion is computed by dividing the adjusted cost basis for determining gain upon the sale or other disposition of the property by the number of units of oil or gas remaining as of the taxable year, and multiplying the depletion unit, so determined, by the number of units sold within the taxable year.[32] The percentage of income depletion deduction is computed by taking 27½ per cent of the gross income from the property during the taxable year, such deduction not to exceed an amount equal to 50 per cent of the net income (computed without allowance for depletion) from the property.[33]

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[28] *Hazel McAdams et al.*, 15 T.C. 231 (1950).

[29] *McAdams et al.* v. *Commissioner* (5 Cir. 1952), 198 F. 2d 54, 42 AFTR 310.

[30] 1954 IRC § 614(a); G.C.M. 24094, 1944 C.B. 250.

[31] 1954 IRC § 614.

[32] 1954 IRC § 612; Reg. 118, § 39.23(m)-2.

"Gross income from the property," for the purpose of computing percentage depletion, means the amount for which the taxpayer sells the oil and/or gas in the immediate vicinity of the well. If the oil or gas is manufactured or converted into a refined product or transported from the property prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or posted field price of the oil or gas before conversion or transportation.[34]

In computing the net income from the property, for the purpose of computing 50 per cent of such net income, deductible items directly attributable to a specific interest or property are deductions only in computing the net income from that interest or property. Overhead or general items of deduction must be fairly allocated between (1) depletable properties and the activities relating thereto and (2) all other properties and activities. The part thereof allocable to depletable properties must then be fairly apportioned to the several specific properties.[35]

Ordinarily, an operator must use the cost method of computing the depletion deduction for the first year of development of a particular property, because of the fact that intangible expenses must be deducted in arriving at the net income from the property and the percentage depletion deduction cannot exceed 50 per cent of such net income. Accordingly, it may be wise for the operator to use discretion in programming his drilling activities. If the drilling is done toward the first of the year, substantial production may result in no percentage depletion allowance, because, after the intangible costs are taken into account, there may be no net income from the property. It may be better, taxwise, to drill toward the end of the year, in order to sacrifice as little of the percentage depletion deduction as possible.

If it is going to be necessary to drill several wells on a lease, it might be advisable, taxwise, to try to drill all of the wells during one taxable period. If this is not possible, then it might be advisable to time the drilling, after the first taxable period, so that the intangible expenses will not reduce the net income to a point where the percentage depletion deduction will be reduced to less than 27½ per cent of the gross income.

If 50 per cent of the net income from a particular property is less than 27½ per cent of the gross income for the taxable period, some tax benefit may be gained by selling an oil payment, to be paid out of production of the following year. For example, if the gross income from the property during the first year of development amounts to $100,000 and deductible expenses, including intangibles, amount to $80,000, percentage depletion will be limited to $10,000 (50 per cent of $100,000 minus $80,000). If a $50,000 oil payment is sold, gross income will be increased to $150,000 and allowable percentage depletion will be increased to $35,000 (50 per cent of $150,000 minus $80,000). The net effect is that a depletion deduction of 50 per cent will be allowed on the income realized from the sale of the oil payment, whereas a deduction of only 27½ per cent will be allowed if the income is not realized until the following year. Assuming a constant income tax bracket for each year, some tax saving might be effected.

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[33] 1954 IRC § 613; Reg. 118, § 39.23(m)-4.

[34] Reg. 118, § 39.23(m)-1(e).

[35] Reg. 118, § 39.23(m)-1(g); G.C.M. 22956, 1941-2 C.B. 103.

5. Accounting for the Proceeds Realized from the Sale or Exchange of Oil Properties

Assuming that the provisions of Sec. 1221 of the Internal Revenue Code of 1954 are otherwise met, the gain realized from the sale or exchange of oil properties held for more than six months at the time of the sale or exchange is taxable as long-term capital gain. If the transaction is considered to be a lease or sublease, the cash consideration is considered to be bonus money in the hands of the recipient subject to the depletion deduction.[36] It is important, therefore, to consider the tax consequences of various forms of assignments of oil and gas interests.

1. If the operator assigns a working interest for a cash consideration and retains an overriding royalty, the cash consideration is considered to be bonus money subject to depletion.[37]

2. If an operator assigns a working interest for a cash consideration and retains an oil payment, payable out of a share of production, the cash consideration is considered to be proceeds from a sale, subject to capital gain treatment, and the proceeds from the retained oil payment, when received, constitute ordinary income subject to depletion.[38] The basis of the working interest must be apportioned between the interest assigned and the oil payment retained.[39]

3. If the operator assigns a working interest for cash, and in the assignment retains an oil payment *and* an overriding royalty, the cash consideration is considered to be bonus money subject to depletion.[40]

4. If an operator assigns a producing working interest with the equipment thereon for a cash consideration and reserves an overriding royalty, the cash consideration is first applied against the adjusted basis of the depreciable equipment, and the balance, if any, is considered bonus money subject to depletion.[41]

5. If an operator assigns a producing working interest and the equipment located on the premises for a cash consideration plus an oil payment payable out of the leasehold interest assigned, the cash consideration is first applied to the adjusted basis of the depreciable equipment, and the balance, if any, is considered to be proceeds realized upon the sale of an asset. The basis of the leasehold interest must be allocated between the interest assigned and the oil payment retained.[42]

6. If an operator sells an oil payment carved out of a working interest and pledges the proceeds from the sale of the oil payment to the development of the property, the operator realizes no taxable income from the sale of the oil payment and the use of the proceeds for the pledged purpose is not regarded as an expenditure by the operator.[43]

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[36] *Burnet* v. *Harmel*, 287 U.S. 103 (1932), 11 AFTR 1085.

[37] G.C.M. 22730, 1941-1 C.B. 214; *Hogan* v. *Commissioner* (5 Cir. 1944), 141 F. 2d 92, 32 AFTR 246.

[38] *Commissioner* v. *Fleming* (5 Cir. 1936), 82 F. 2d 324, 17 AFTR 628.

[39] *Columbia Oil & Gas Co.* v. *Commissioner* (5 Cir. 1941), 118 F. 2d 459, 26 AFTR 715.

[40] *Palmer* v. *Bender*, 287 U.S. 551 (1933), 11 AFTR 1106.

[41] *Louisiana Land & Exploration Co.*, 6 T.C. 172 (1946); *Choate* v. *Commissioner*, 324 U.S. 1, 33 AFTR 297.

[42] *Columbia Oil & Gas Co.* v. *Commissioner*, footnote 38, above; G.C.M. 23623, 1943 C.B. 313.

[43] G.C.M. 22730, 1941-1 C.B. 214; I.T. 4003, 1950-1 C.B. 10; G.C.M. 24849, 1946-1 C.B. 66.

7. It is the position of the Commissioner that the assignment of any oil payment right (not pledged for development), which extends over a period less than the life of the depletable property interest from which it is carved, is essentially the assignment of expected income from such property interest; and the consideration received for the assignment constitutes ordinary income to the assignor. Recent court decisions, however, appear to have overruled this position of the Commissioner.[44]

8. It is the position of the Commissioner that the consideration received for the assignment of an oil payment right which (a) constitutes the entire depletable interest of the assignor in the property, or (b) a fraction extending over the entire life of the property, represents proceeds realized from the sale of an asset.[45]

If oil property is exchanged for property of a like kind, within the meaning of Sec. 1031(a) of the Internal Revenue Code of 1954, the transaction is considered to be a tax-free exchange. The important question for consideration is whether or not the property received in exchange is property of a like kind within the meaning of Sec. 1031(a). The Board of Tax Appeals has held [46] that the exchange of an oil payment for an overriding royalty was not an exchange of property of a like kind and thus constituted a taxable exchange. The Board laid particular emphasis on the fact that the oil payment right terminated after a specified amount of proceeds had been derived from the oil and gas produced from the lease, whereas the overriding royalty continued for the entire productive life of the leased property.

The United States Court of Appeals for the Fifth Circuit has held [47] that unimproved country land and an improved city lot, received in exchange for an undivided interest in "oil, gas and other minerals, in, on and under, and that may be produced from" the country land, constituted property of a like kind, within the meaning of the statute. The Court pointed out that both the property exchanged and the property received in exchange were real property and indicated that no distinction should be made because of dissimilarity in grade or quality, so long as all property involved was real property.[48] This indication was strengthened by a recent decision of the same court,[49] wherein it was held that the exchange of an undivided fractional oil, gas, and other mineral interest in one locality for a limited overriding royalty and mineral interest (oil payment) in and to the oil in and under certain leasehold estates in another locality, was, under Section 112(b)(1) of the Internal Revenue Code of 1939, an exchange in kind of property held for productive use or investment. The language of the Court that, "Certainly . . . the exchange here of mineral interests for mineral interests was not an exchange of property of unlike kind merely because one of the mineral interests was of indefinite, the other of definite, duration" apparently overruled the earlier decision of the Board of Tax Appeals in the *Midfield Oil Company* case.[50]

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[44] In G.C.M. 24849, 1946-1 C.B. 66, the Chief Counsel, without expressing any opinion as to the status of in-oil payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved, expressed the opinion that consideration (not pledged for development) received for the assignment of a short-lived in-oil payment carved out of any type of depletable interest in oil and gas (including a larger in-oil payment right) constituted ordinary income subject to the depletion allowance in the assignor's hands. In I.T. 4003, 1950-1 C.B. 10, the Commissioner concluded that there was no legal or practical basis for distinguishing between short-lived and long-lived in-oil payment rights and announced that the rule should apply to the assignment of any in-oil payment right which extends over a period of less than the life of the depletable property interest from which it is carved. In *John David Hawn*, 23 T.C. 516 (1954), the Tax Court, citing *Lester A. Nordan*, 22 T.C. 1132 (1954), held that the oil payment which petitioner transferred was a capital asset and the gain realized was taxable as long-term capital gain. In *Caldwell* v. *Campbell* (5 Cir. 1955) 218 F. 2d 567, the United States Court of Appeals for the Fifth Circuit held that the taxpayer realized capital gain on the proceeds of the sale of a carved-out oil payment, and the gain could be reported on the installment basis.

[45] I.T. 4003, 1950-1 C.B. 10.

[46] *Midfield Oil Co.*, 39 B.T.A. 1154 (1939).

[47] *Crichton* v. *Commissioner* (5 Cir. 1941), 122 F. 2d 181, 27 AFTR 824.

[48] Following is the language used by the Court: "For the regulation and the interpretation under it, leave no doubt that any gain or loss is realized by one, other than a dealer, from an

There has been an increasing tendency in recent years to utilize oil payments in cases involving the sale of producing oil and gas properties. The technical procedures assume many forms, but under any of the alternatives at least these two objectives are the same: (1) The vendor of the property will be accorded capital gains treatment on the proceeds he receives from the sale, and (2) most of the purchase consideration will in effect be supplied by production attributable to the oil payment. The advantage of utilizing the oil payment is that the purchaser may acquire an interest in the property with a relatively small outlay of his personal funds, and the proceeds of production received under the oil payment, which in effect are used to purchase the property interest, are substantially tax-free.

One method of accomplishing the desired results is for the owner of the property to retain a carved-out oil payment and sell his interest, subject to the outstanding oil payment, for a comparatively small consideration. The carved-out oil payment is then sold to an investor, who usually finances this purchase through a bank or other money-lending institution. The amount to be recovered under the oil payment will of course be large enough to allow the investor to realize a profit from his investment. Another alternative is for the outside investor to assume the role of a middleman. The owner of the oil and gas property interest sells his entire interest to the middleman investor, who then carves out an oil payment and sells the remainder of his interest to the purchaser, who takes the interest subject to the outstanding oil payment. The middleman investor takes cost depletion on the proceeds of his oil payment, and only his net profit is taxable income.

The use of the oil payment is usually confined to the sale of working interests, but it can also be used in the sale of royalty interests. To assure the approval of the Internal Revenue Service, all negotiations must be at arm's length; the oil payment must be payable solely from the proceeds of production; and the sale of the oil payment must not precede the sale of the retained working or royalty interest. Where the sale of a working interest is involved, the owner of the working interest should receive enough of the proceeds from production to pay all costs of operation during the payout period of the oil payment.

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exchange of real estate for other real estate, and that the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property. It was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes, and in capacities for profitable use."

[49] *Fleming et al.* v. *Campbell* (5 Cir. 1953), 205 F. 2d 549, 44 AFTR 107.

[50] *Midfield Oil Co.*, footnote 46, above.

6. Agreements by Which Oil and Gas Producers May Develop Properties Without Using Personal Funds

Development of leasehold property by an operator without an outlay of his personal funds is not unusual in the oil and gas industry. The operator may enter into an agreement with a drilling contractor, for the purpose of developing the property, whereby the contractor will bear all drilling costs, such as labor, fuel, supplies, and similar expenses, and agree to furnish all necessary equipment, such as casing, tubing, "Christmas trees," flow lines, separators, lease tanks, and the like. In consideration therefor, the contractor will receive, in the form of an oil payment, a percentage of the oil and/or gas, if, as, and when produced, until the agreed sum has been recouped. The amount ultimately realized by the driller may be twice as much as the well would cost if the driller were to be paid in cash for fulfilling his contract to drill to an agreed depth, regardless of the outcome of the drilling. The size of this payment will depend upon the risks involved and the total amount and daily volume of the production expected to be obtained from each well.

Under the type of contract discussed in the preceding paragraph, the operator is entitled, from a tax standpoint, to the equivalent of 100 per cent depreciation on the equipment during the first year, and he does not have to report as income the production pledged to fulfill the oil and gas payment.[51] Since the driller has an economic interest in the oil and gas in place, the courts have ruled, and the Commissioner has agreed, that he is entitled to depletion. Of course, the driller in most instances would elect to take cost depletion, because the cost of drilling and equipping the well must be capitalized as the cost of the oil payment.[52]

It is not necessary that an operator rely on a drilling contractor to finance the drilling in order to gain this advantage. An operator may in effect borrow money for the purpose of drilling and equipping wells by selling an oil payment to an outsider and pledging the proceeds of the sale to the development of the property. To the extent that the proceeds of the sale of the oil payment are used for developing the property, the operator has no deductible expense, and he has no cost basis in the equipment installed. This method of financing may be advantageous to the operator if he has no income during the current year against which to offset the intangible costs.

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[51] G.C.M. 22730, 1941-1 C.B. 214.

[52] See G.C.M. 22730, 1941-1 C.B. 214, and G.C.M. 24849, 1946-1 C.B. 66. G.C.M. 22730 (at page 221) states in part: ". . . The point assumes importance in view of the many contracts entered into by owners of lessee interests, with well drillers to drill wells, equipment dealers to furnish equipment, and investors to furnish money for use in developing leased property in return for agreements to make stated payments out of a share of the oil. By such arrangements, a lessee commonly lessens his own investment and the risks and burdens attending development by agreements to share the investment obligation and the proceeds of production. The lessee or assignee, like the lessor or assignor who retained a share interest in production having a value equivalent to that of the lessor's prior interest but passed on to the lessee the investment obligations and risks that attend development for a share in production, has parted with no capital interest but has merely in turn given another a right to share in production in consideration of an investment made by such other person. If the driller or equipment dealer is making an investment by which he acquires an economic interest in oil and gas in place, expenditures made by him represent capital expenditures returnable tax-free through the depletion allowance rather than by way of expense deductions, and the oil payment rights acquired do not represent payment in property for services rendered or supplies furnished."

Some operators may wish to dispose of their producing properties in such a manner that someone else will be liable for the operating expenses and at the same time retain for themselves an assured future income from the property. This may be accomplished by selling the leasehold, together with all of the equipment thereon, for cash and retaining an oil payment out of the working interest. If the vendor wishes to retain a specified amount each month for a certain number of years, he can usually calculate the approximate size of the oil payment he must retain. The income realized from the portion retained is taxable as ordinary income, subject to the depletion deduction.[53]

By resort to the carried interest or net profits type of arrangements (discussed under Section 2), the owner of a lease may retain an economic interest in the property and yet rely on other parties to furnish the costs of development. Another very popular type of arrangement is the so-called "farm out," under which a lease owner may assign the working interest to another party and retain an economic interest in the form of an overriding royalty or an oil payment. The tax consequences of the farm out are discussed in Section 5.

In areas of unproven production, operators may receive financial assistance from other lease owners in the area who are willing to contribute, as a means of spreading the risk, toward the cost of drilling a "wildcat" well. Such financial assistance is usually in the form of "dry hole" or "bottom hole contributions." "Dry hole money" is paid to the operator only if the well is dry or not commercially productive after an agreed depth has been reached. Under the terms of dry hole agreements, no payments are made to the operator if the well produces. In the case of "bottom hole money," the operator receives the contribution regardless of drilling results, provided that the well has been drilled to the agreed depth, or oil or gas is discovered in commercial quantities at a lesser depth. If the drilling results in a dry hole, the contribution payment is deductible as a loss under Sec. 165(a) of the Internal Revenue Code of 1954; but if the payment is a "bottom hole" contribution, and the well is a producer, the amount of the contribution must be capitalized as additional leasehold cost of the lease or leases owned by the contributor in the area of development.[54]

Although there appears to be no ruling on these specific points, it would appear proper for the recipient to apply the amounts received to a reduction of the intangible development costs if the well is a producer and to a reduction of dry hole expense if the well is a dry role. The situation is somewhat analogous to the sale of an oil payment, the proceeds of which are pledged for development.[55]

7. Accounting for Joint Operations of Oil and Gas Leases

A high percentage of the crude oil and gas produced today is produced from leases that are owned by more than one working interest owner. This circumstance is occasioned primarily because of the desire of oil and gas producers to spread the risks of this highly hazardous industry. Needless to say, this circumstance also gives rise to many accounting and income tax problems that are not prevalent in other industries.

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[53] *Cullen* v. *Commissioner* (5 Cir. 1941), 118 F. 2d 651, 26 AFTR 887; *Hammonds* v. *Commissioner* (10 Cir. 1939), 106 F. 2d 420, 23 AFTR 379; *Commissioner* v. *West Production Co.* (5 Cir. 1941), 121 F. 2d 9, 27 AFTR 618; *Commissioner* v. *Jones* (5 Cir. 1936), 82 F. 2d 329, 17 AFTR 632; *Commissioner* v. *Williams* (5 Cir. 1936), 82 F. 2d 328, 17 AFTR 633, G.C.M. 22730, 1941-1 C.B. 214; I.T. 3693, 1944 C.B. 272.

[54] Special Ruling, May 4, 1945; II-3 *Oil and Gas Tax Quarterly*, page 141.

[55] G.C.M. 24849, 1946-1 C.B. 66.

In most cases of multiple working interests, the leases are operated under written contracts commonly known in the oil and gas industry as "joint operating agreements." Under the terms of the ordinary joint operating agreement, one party to the agreement is designated as the "operator." The "operator" usually has the duty to develop and operate the lease and to furnish the "non-operators" periodic statements showing in detail all costs incurred in the development and operation of the lease. Accounting for the joint operations is usually in accordance with the terms of an "Accounting Procedure," which in most cases is a printed form (with certain details supplied) attached as an exhibit to the operating agreement.

There is much disagreement among income tax authorities as to the proper treatment of joint operations of oil and gas leases for Federal income tax purposes. Most of the uncertainty seems to stem from an over-all consideration of the opinions of the Commissioner, as expressed in I.T. 2749, I.T. 2785, I.T. 3930, and Rev. Rul. 54-42;[56] the Tax Court decision in *Bentex Oil Corporation* v. *Commissioner*;[57] and subparagraph (b) of section 703 and subparagraphs (a) and (c) of section 761 of the Internal Revenue Code of 1954.

In I.T. 2749 and I.T. 2785 the Commissioner apparently reached the erroneous conclusion that *all* co-ownerships of oil and gas leases constitute "joint ventures" and hence are "partnerships" within the meaning of the Internal Revenue Code. In I.T. 2749 the Commissioner considered a set of facts wherein the subsidiaries of the taxpayer corporation were co-owners of a large number of oil and gas leases. The gross revenue from the properties was paid to and accounted for by the co-owners monthly. Expenditures in the development and operation of the properties were paid by the co-owners monthly in proportion to their interests. The accounting method adopted resulted in a complete periodical accounting for revenue and expense in the same manner as in the case of a separate piece of property. The Commissioner concluded: "In the instant case the co-ownerships of the oil and gas leases and the operations thereunder may be fairly considered as falling within the broad scope of the term 'joint venture.' . . . It is held in the instant case that the co-ownerships of the leases and the development of the property constitute partnerships within the meaning of section 1111(a) 3 of the Revenue Act of 1932."

It might be reasoned that the opinion expressed in I.T. 2749 applied only to facts corresponding to "the instant case." In I.T. 2785, however, the Commissioner made the following all-inclusive statement: "Reference is made to the ruling in I.T. 2749, supra, holding that co-ownership of oil and gas leases and the development of the property either by individuals or corporations, or both, constitute partnerships within the meaning of section 1111(a) 3 of the Revenue Act of 1932; and that such co-ownerships must file partnership returns." (The Commissioner thus indicated that the "partnership" relation arose out of the mere "co-ownership" of oil and gas leases, irrespective of any contractual agreement with respect to the development and operation of the lease that might be made between such co-owners.) The Commissioner then hastened to add that, in the class of cases governed by that ruling, it would be considered sufficient compliance with I.T. 2749, if the operating co-owner, under his own name, filed a return Form 1065 showing the following information: "In lieu of filling in the several items and schedules on the partnership return (Form 1065) there should be attached to the return a schedule showing the total working interest, names and addresses of the co-owners, the percentage of each co-owner's interest in the co-ownership, total costs and expenses billed each co-owner with respect to drilling for and producing the oil and gas, and the total revenue credited in those cases where the operating co-owner distributed revenue to the other co-owners (by way of credit or cash) from the sale or other disposition of the co-owners' oil and gas. . . ."

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[56] I.T. 2749, XIII-1 C.B. 99; I.T. 2785, XIII-1 C.B. 96; I.T. 3930, 1948-2 C.B. 126; Rev. Rul. 54-42, 1954-1 C.B. 64.

[57] *Bentex Oil Corporation,* 20 T.C. 565 (1953).

For a time after the issuance of I.T. 2785, most oil and gas producers attempted to conform to the provisions of I.T. 2785 by filing "qualified" Forms 1065. In many cases, however, this practice soon led to utter confusion and was discontinued. Non-operators complained that they were neither "partners" nor "joint adventurers" with the operators and pointed to the terms of the joint operating agreements in support of their contentions. They did not want their positions as individual operators, which legal counsel had been so careful to protect, jeopardized by the filing of any form of partnership returns, which might be used in purely legal considerations as evidence that they were partners (mining partners or otherwise) and hence were liable for the obligations of the other co-owners. Further, they contended that the qualified Forms 1065 were of absolutely no help in filing their own individual income tax returns. The Forms 1065 might be prepared on the basis of fiscal years corresponding with the taxable years of the operators, whereas the non-operators might use taxable years ending on different dates. Further, the qualified Forms 1065 did not present depreciation schedules and much other detailed information necessary for preparing the individual income tax returns.

As indicated in the preceding paragraph, many co-owners of leases were insistent that the joint operating agreements be drafted so as clearly to indicate that the liability of each co-owner would be several and not joint or collective and that no partnership or joint venture relationship of any kind be created. Following is typical wording employed in joint operating agreements to effect such desired results:

> The liability of each non-operator to operator for costs and expenses incurred shall be several and not joint or collective. Operator and each non-operator shall be responsible only for its obligations, as herein set out, and shall be liable only for its proportionate share of the cost of developing and operating jointly owned property. Nothing herein shall be construed as an assignment or transfer of the leases or an interest therein as between the parties hereto.
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> It is expressly agreed that it is not the purpose or intention of this agreement to create as between the parties hereto, nor shall the same be construed as creating, any mining partnership, commercial partnership, ordinary partnership or other partnership relation, nor shall the operations of the respective parties hereunder be considered or construed as a joint venture. Operator represents that in the performance of this contract, its employees and the employees of its subcontractors are not and shall not be considered as employees of any non-operator for any purposes whatsoever, and the liabilties of the parties hereto are limited to the provisions of this contract.

In 1948 the Commissioner issued the now-famous I.T. 3930.[58] To some income tax authorities I.T. 3930 cleared up the whole picture as to the income tax status of joint operations of oil and gas leases. To other authorities I.T. 3930 only served to add to the confusion. Some authorities concluded that, because of the lack of a joint profit objective, it seemed proper to conclude that the typical joint operating agreement is a mere co-tenancy and is neither a partnership nor an association taxable as a corporation.[59] To the contrary, at least one writer expressed the opinion that, for Federal income tax purposes, joint operating agreements create either (1) ordinary trusts, taxable as an individual, (2) partnerships, the income of which is taxable to the individual partners, or (3) associations, taxable as corporations.[60]

In I.T. 3930 the Commissioner considered primarily the subject of associations taxable as corporations. After citing many cases, the Commissioner concluded that, in order to classify an organization as an association taxable as a corporation, (1) there must be associates, (2) the object of the organization must be joint profit, (3) there must be continuity of life, and (4) there must be centralized control of group affairs. The Commissioner then recognized that the first two requisites are common to all forms of business organizations and form the essential test of associated, as distinguished from individual, enterprise. He then ruled that "all forms of unincorporated business organizations for joint profit are partnerships for income tax purposes except those organizations which by attaining the continuity of life and centralization of management characteristic of the form of organization, are by definition associations taxable as corporations." Under this reasoning of the Commissioner, the absence of a joint profit objective would preclude the existence of either a partnership or an association taxable as a corporation. Indeed, the following language of the Commissioner speaks for itself:

> . . . Accordingly, it seems clear that if the joint objective is limited to development and the extraction and processing of mineral (at joint cost and expense to be met by contributions of the respective participants) for division in kind or for sale for the accounts of the several participants individually, the test of a joint venture for joint profit is not met. An organization created by such an agreement does not qualify as a corporation as defined in section 3797(a) (3) of the Internal Revenue Code. As such agreements commonly allow the participants to take their shares of the mineral in kind (or provide for the sale of the shares of the respective participants for their individual accounts under revocable agency powers), the sale of the mineral, even though made by the operator, is a sale by or on behalf of the individual participants. In such cases there is no joint profit contemplated or realized by the associates. That being true, such organizations may be classified for Federal income tax purposes as joint ventures or partnerships only in a qualified sense. Under I.T. 2749 . . . and I.T. 2785 . . . such joint operators are required to file qualified partnership returns showing only items of gross income and deduction. If such a qualified partnership return were not required, it would be necessary for each of the joint owners to submit the same information by schedules attached to their individual returns.

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[58] I.T. 3930, footnote 56, above.

[59] Grant E. Judge "Problems of the Oil and Gas Industry: Federal Income Tax Problems," *Proceedings of New York University Ninth Annual Institute on Federal Taxation*, beginning at page 459.

[60] Kenneth E. Barnhill, Jr., "Taxation of Oil and Gas Operating Agreements—The Scope and Application of I.T. 3930," *Rocky Mountain Law Review*, February 1954, Vol. 26, No. 2, page 133.

Thus, the Commissioner indicated that the only reason for the requirement of the filing of a qualified partnership return, under I.T. 2785, was to eliminate the necessity for each joint owner submitting the same information by schedules attached to his own return. Since, however, in reality, the filing of a qualified partnership return (showing only items of gross income and deduction) does not eliminate the necessity of showing full details on the individual returns (because depreciation and various expense items like taxes, not paid by the operator, must also be shown) there appears to be no real necessity for filing qualified partnership returns.

In *Bentex Oil Corporation* v. *Commissioner*,[61] the petitioner was a co-owner of an oil and gas lease. The co-owners had no formal written agreement or definite arrangement as to the development and operation of the lease. As a matter of procedure, the co-owners operated as they would under a typical joint operating agreement. Partnership returns were filed on the lease upon the advice of counsel that the then rulings of the Commissioner required such filing and treatment. On the returns it was stated that the nature of the organization was a "joint venture," and deductions were taken for intangible drilling and development costs. The petitioner, in a protest, contested the disallowance by the Commissioner of the intangible drilling and development costs. This controversy was settled on the basis that the venture was a partnership, and that the intangible drilling and development expenses were to be allowed as deductions. In later years the petitioner, in order to compute a larger excess profits tax credit, contended (1) that the subject lease operations did not constitute a partnership or joint venture and therefore had no right to exercise an option to expense intangible drilling and development costs and (2) assuming that the operation be held to be a partnership or joint venture under the statute, as such it was not a "taxpayer" and consequently had no right to exercise such option. The Tax Court held that the lease operations constituted a joint venture or partnership within the broad definition of that term in section 3797 of the Internal Revenue Code and that the partnership was a "taxpayer," within the meaning of article 23(m)-16 of Regulations 94, and thus had the right to make the election.

There are those who believe that the *Bentex* case is authority for the principle that *all* oil and gas lease joint operations (except those qualifying as trusts or associations taxable as corporations) constitute partnerships or joint ventures for Federal income tax purposes. Although it may be argued that the Tax Court's opinion makes such an inference, nothing in the language of the opinion states that the holding applies to facts other than "the facts set out in our Findings of Fact." The Tax Court had previously held [62] that one who willingly or through indifference allows others to use his funds and then acknowledges that he is a joint venturer with them must be recognized as a joint venturer for tax purposes despite his protestations of ignorance of the whole situation.

In C. A. *Happold* [63] the Tax Court had for consideration the direct question of whether or not a joint owner of oil and gas leases was a "partner" for Federal income tax purposes. The Tax Court found that the petitioner had owned an undivided interest in the leases since 1939, but the legal title had not been transferred to him until 1939. The following excerpts from the Tax Court's opinion state the necessity for the determination and the reasons for holding that neither a partnership nor a joint venture was involved:

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[61] *Bentex Oil Corporation,* footnote 57, above.

[62] See *Dennis Halkins,* 12 T.C. 1091 (1949).

[63] C. A. *Happold,* par. 42,625 Prentice-Hall Memorandum T.C. (1942), affirmed (5 Cir. 1944) 141 F. 2d 199, 32 AFTR 271. See, also, Judge Rives' discussion on this subject in his opinion in *McAdams et al* v. *Commissioner,* (5 Cir. 1952) 198 F. 2d 54, 42 AFTR 310.

> For reasons which we are about to state, it is our view that petitioner's ultimate position is sound in the main, but on a ground which he advances as an alternative rather than as the principal contention. It seems to us that the preponderance of the evidence indicates that petitioner was from the beginning a tenant in common in the income-producing property, and that what he received in 1939 was no more than the formal evidence of property rights obtained at the inception of the transaction.
>
> It will be seen that all of this reasoning is acceptable and consistent only on the assumption that what petitioner obtained was a direct participation in the ownership of the property. If from the beginning the arrangement was a joint venture, with the consequence that the leases were no more than partnership property, the 1939 document would have constituted a change in the relationship of the parties and in the title to the property, and it could not be said that thereby it was intended merely to formalize a situation already existing. Such a conclusion is inconsistent with the recitals to which we have already referred that the second party was the owner prior to the execution of that document of an interest in the leases, and the assumption that this was the same interest as that which the document conferred upon him formally. And the remaining characteristics of a joint venture which one would normally expect to find, such as participation in liabilities and a voice in management, do not appear from this record. *Bolding* v. *Camp et al.*, (Tex.), 6 S.W. (2d) 94, modified 7 S.W. (2d) 867; *Cox* v. *Bond* (Tex.), 91 S.W. (2d) 479.

The definition of "partnership" for Federal income tax purposes has been substantially the same since the Revenue Act of 1932. The courts have held that this broad definition is not all-embracing of any business or financial operation carried on by two or more individuals (other than a trust, corporation or estate),[64] and they have repeatedly held that a partnership or joint venture will not be recognized in the absence of an intention to form one.[65] The House and Senate Committee reports proposing the Internal Revenue Code of 1954 have indicated that there was no intention to change the definition of "partnership" under the new law.

Following the *Bentex* decision, the Commissioner, in Rev. Rul. 54-42,[66] ruled: "The election to charge to expense intangible drilling and development costs incurred in connection with the oil operations of a partnership that files its return and computes its income on Form 1065 is exercisable by the partnership. The partnership election is controlling, irrespective of the election of the individual partners as to their own operations." This ruling may be accepted as an accurate statement of the income tax law, and it is consistent with section 703(b) of the 1954 Code. It should be noted that the rule is limited to a *partnership* that files its return and *computes its income* on Form 1065. Qualified returns, as required under I.T. 2785,[67] are therefore excluded from the scope of this ruling, because such returns show only total costs billed and total revenue credited.

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[64] See *Estate of Edgar S. Appleby*, 41 B.T.A. 18 (1940), affirmed (2 Cir. 1941) 123 F. 2d 700, 28 AFTR 396.

[65] See *Commissioner* v. *Tower*, 327 U.S. 280, 34 AFTR 799 (1946); *Commissioner* v. *Culbertson*, 337 U.S. 733, 37 AFTR 1391 (1949); *L. C. Olinger*, 10 T.C. 423 (1948); *Lucia Chase Ewing*, 20 T.C. 216 (1953), affirmed (2 Cir. 1954) 213 F. 2d 438, 45 AFTR 1578.

[66] Rev. Rul. 54-42, 1954-1 C.B. 64.

Section 703(b) of the Internal Revenue Code of 1954 provides that any election affecting the computation of taxable income derived from a partnership, except that relating to taxes of foreign countries and possessions of the United States, shall be made by the partnership. Section 761(a) provides, however, that under regulations the Secretary or his delegate may, at the election of all of the members of an unincorporated organization, exclude such organization from application of the provisions relating to partnerships, if such unincorporated organization is availed of for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, and if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

§1.761 of the "Proposed" Partners and Partnerships Regulations indicates that the mere joint ownership of business or investment property would be sufficient to create a partnership for income tax purposes, although such reasoning is altogether inconsistent with a long line of court decisions. Under the "Proposed" Regulations, the production of oil and gas in accordance with the provisions of a joint operating agreement would create a partnership (if not a corporation or a trust). If the joint operating agreement is entered into after December 31, 1955, the election to be excluded from the provisions of subchapter K must be included as part of the joint operating agreement, a copy of which must be attached to the first partnership return required to be filed. Where working interests are operated under an agreement entered into prior to January 1, 1956, the participants shall be considered as agreeing to separate accounting as individuals, and the election under section 761(a) with respect to the exclusion of partnerships from the application of all or part of subchapter K is not available unless the operating agreement is revised so that the value of the oil and gas produced is established and accounted for as gross income of the partnership.

The "Proposed" Regulations provide that in the case of any joint operating agreement therein referred to, a qualified partnership return Form 1065 must be filed by the operating co-owner, under the operating co-owner's name, for the first taxable year in which any activity occurs under the operating agreement and for each taxable year thereafter. The filing of a qualified partnership return presupposes that each participant in the operating agreement may adequately determine his income with respect to his undivided interest without the computation of partnership taxable income, because the qualified form of partnership return shows neither the total partnership taxable income nor that of any of the individual participants. It would seem that, except as information returns to show the names, addresses, and percentages of interest of the individual co-owners, qualified partnership returns serve no useful purpose.

Whether or not the participants under joint operating agreements intend to form partnerships or joint ventures, and irrespective of the legal attributes of the contractual agreements—in the light of the broad wording of the "Proposed" Regulations, all joint operating agreements drafted after December 31, 1955, should include words of election by the participants to be excluded from the application of the provisions of subchapter K of the Internal Revenue Code of 1954, and copies of such joint operating agreements should be filed with the Commissioner with the first qualified partnership returns. As an added protection of the rights of the participating co-owners to be treated as individuals for the purpose of making their respective elections to expense intangible drilling and development costs, it is recommended that a disavowal of any partnership or joint venture relationship be included with any qualified partnership return Form 1065 that may be filed.

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[67] I.T. 2785, XIII-1 C.B. 96.

8. Miscellaneous Changes Under the Internal Revenue Code of 1954

The provisions of the Internal Revenue Code of 1954 relating to depletion, intangible drilling and development costs, and joint operations of leases have been discussed elsewhere in this Chapter. Several other provisions of the new Code grant relief to the oil and gas producer. It is not within the scope of this Chapter to discuss all of the changes in the Code that can possibly be applied to the oil and gas industry, but a few of the changes are deemed to be of sufficient importance to merit consideration.

Among the most significant changes under the new Code, from the standpoint of the oil and gas producers, are the provisions relating to the net operating loss deduction.[68] For years ending after December 31, 1953, it is not necessary to limit the deduction for depletion to an amount computed on the basis of cost. In other words, the percentage depletion deduction may be used. For an oil and gas producer other than a corporation it is no longer necessary to eliminate net losses arising from the sale of depreciable or real property used in the trade or business. Net operating losses may now be carried backward for a period of two years and forward for a period of five years.

Section 270 of the Internal Revenue Code of 1954 succeeds section 130 of the 1939 Code. Under this section, if net losses in excess of $50,000 are incurred by an individual in carrying on any trade or business for five or more consecutive years, the taxable income of such individual shall be recomputed for each year by disallowing the amount of such losses in excess of $50,000 for each year. Under the 1939 Code, deductions for taxes and interest were not considered in determining the amount of the net loss. In addition to the deductions for interest and taxes, the 1954 Code also provides for the exclusion of deductions for abandonment and casualty losses connected with the trade or business and intangible drilling and development costs in determining the amount of the net loss.

The new methods for computing depreciation, as provided under section 167 of the 1954 Code, are available to the oil and gas producer, as they are to any other taxpayer. Section 611(a) provides that in the case of mines, oil and gas wells, and other natural deposits, there shall be allowed a deduction for depletion and for depreciation of improvements "according to the peculiar conditions in each case." In any case in which it is ascertained as a result of operations or development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) must be revised and the allowance for subsequent taxable years must be based on such revised estimate.

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[68] IRC 1954 § 172.

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Part IV

BUSINESS EXPENSES AND LOSSES

22

Compensation and Incentives for Executives

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Of approximately 40,000,000 men and women employed in business in the United States,[1] perhaps 100,000 are members of top management and 500,000 are members of middle management.[2] Taxes and inflation, which together appear to have affected the management group more seriously than other employees, have contributed to the development of supplemental forms of compensation and incentives for them.

The small or growing company seeking to attract new management may not succeed to-day simply by the proffer of a substantial salary increase. The large, established company may also find it necessary to offer inducements other than salary in order to retain executives against competitors or against the attraction of a business of their own, and, in any event, in order to continue to bring forth the all-out efforts essential to the leadership of our industrial enterprises.

To accomplish these objectives, various plans have been developed. To-day, every corporation lawyer and accountant and every tax expert must have at least a passing familiarity with such plans, their advantages, their disadvantages, and the tax questions they present.

1. Points to Consider

Section
What are the company's tax needs? 2
What are the executive's tax needs? 3
How to provide benefits to the executive that are not taxable 4
  Expense allowances 4(a)
  "Perquisites" 4(b)
  Group insurance 4(c)
    Life insurance
    Disability and medical benefits

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[1] A total of 53,455,000 were employed in 1952, of which 46,401,000 were non-agricultural and 6,390,000 were government employees. U.S. Dept. of Commerce, Bureau of Labor Statistics, *Statistical Abstract* (1953), page 179 (Table 209) and page 180 (Table 210).

[2] The management figures result from a percentage estimate of one and one-half per cent of total business employees, with one-fourth of one per cent estimated as top management executives. See Harold R. Hall, *Some Observations on Executive Retirement*, page 4, note 1. Boston: Harvard University, 1953. Surveys confined to large companies (20,000 or more employees) assume 1 per cent of all employees in such companies to be executives and one-tenth of 1 per cent to be top management. See Bursk, footnote 15, below; Arch Patton, "Are Executives Paid Enough?", *Fortune Magazine*, January 1953, pages 106, 107.

Section
How to provide benefits that are taxable to the executive at capital gain rates 5
  The stock bonus .... 5(a)
  The bargain purchase .... 5(b)
  Purchases through credits and installment purchases .... 5(c)
  The stock option .... 5(d)
  Management stock plans .... 5(e)
How to spread the executive's benefits over future years 6
  Funded plans .... 6(a)
  Non-funded plans .... 6(b)
    Pensions
    Future service contracts
  Death benefits .... 6(c)

Many of these points, or at least aspects of them, are developed in detail in other parts of this book; only highlights will be mentioned here. Moreover, since this book is devoted to tax techniques, the present chapter will concern itself for the most part with tax aspects. It must be borne in mind that, in any given situation, other legal questions, under common law or state statute or federal or state regulation, may be involved[3] and other considerations, such as labor, stockholder, or public relations, must at all times be kept in mind.[4]

2. The Company's Tax Needs

The company's tax objectives relate principally to the tax treatment of its payments to or for the benefit of its executives. The company will, of course, seek to establish all such payments as proper deductions for tax purposes, because, to the extent that compensation paid an executive is a proper deduction, the compensation will cost the company less.

The company will also seek to have compensation payments constitute tax deductions in years of good profits and of high tax rates; during periods of lower profits and lower tax rates the company may seek to defer tax deduction of payments to or for the benefit of executives. As corporate tax rates increase, compensation payments cost the company less and the company will not have the same incentive to keep compensation at a low level, but while it is relatively easy to increase rates of compensation in good times, to reduce them when times are not as good is not so easy. Often, therefore, a company will seek a plan which will permit rates of supplemental compensation to fluctuate with the company's fortunes. Its varied needs in these respects may be served by a qualified profit-sharing plan with its opportunity for employing unused credits for tax carry-back and carry-forward purposes.[5]

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[3] For a comprehensive treatment of the various non-tax as well as tax questions, see George Thomas Washington and V. Henry Rothschild, *Compensating the Corporate Executive*, New York: Ronald Press Company, Rev. Ed. 1951.

[4] See V. Henry Rothschild, "Tax Aspects and Trends in Executive Compensation," *Commercial and Financial Chronicle*, July 2, 1953, page 6; *cf.* Everett J. Mann, "Deferred Compensation and Stock Option Plans may be legal, but are they ethical?", *Journal of Accountancy*, March 1952, Vol. 93, page 324.

[5] 1954 IRC § 404(a)(3); 1939 IRC § 23(p)(1)(C). See also 1954 IRC § 404(d) allowing carry-overs of unused deductions under Section 23(p) of the 1939 Code.

The smaller company, unable to afford the relatively substantial payments that may be required to finance a pension plan or to render a qualified profit-sharing plan attractive to executives, may offer designated top executives future benefits through so-called deferred compensation or future service contracts. Such contracts permit the company to offer future payments, including death benefits, contingent upon the executive's performance and at a time when the company may be better able to afford them.

The closely held company whose stockholders are officers will usually seek to pay by way of compensation as large a proportion of its profits as possible. To the extent that such payments constitute a "reasonable" allowance for compensation, they reduce the tax load on the corporate taxpayer without correspondingly burdening the officer-stockholders as individual taxpayers. Furthermore, with the distribution of the corporation's income in this manner, estate and inheritance tax problems are diminished.

The tax needs of a particular company may conflict with the tax needs, hereafter discussed, of its executives. There has been a significant trend toward denying an employing company a deduction for payments under plans more attractive tax-wise to its executives. The trend is evident in connection with deferred compensation plans. Such plans may be denied the tax advantages of a qualified employees' trust or annuity plan if they benefit executives too significantly.[6] Under plans not so qualified, if the executive receives a vested right in benefits, the company may take a tax deduction immediately, but the executive is then subject to tax even though his benefits may not be received for many years, if at all. On the other hand, if the executive has no vested right in the benefits, he will avoid being taxed until he receives them, but the company has no immediate tax deduction and may lose its tax deduction entirely.[7]

The trend is also evident in connection with stock options. The Revenue Act of 1950[8] conferred important tax advantages upon so-called "restricted" stock options under prescribed conditions, but if the executive receives these advantages, the company will lose its tax deduction.[9] This is true even if the profit realized through a restricted stock option is taxable to the executive as compensation.[10]

The result of this trend is to make certain compensation plans that are highly attractive to executives expensive to the employing company, since the company will obtain no tax deduction and must itself bear the entire cost. The possible sacrifice of tax benefits, however, may be considered as part of the cost of securing capable management. The tax sacrifice is but an element of compensation and its propriety must be judged in terms of the total compensation paid to the executive and the total cost of such compensation to the corporation.[11] Certainly, a plan that imposes too high a tax burden upon executives will lose its value both to the company and to its executives.

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[6] 1954 IRC §§ 401-404, 501(a); 1939 IRC § 165(a)(3)(A) and (a)(4).

[7] 1954 IRC § 404(a); 1939 IRC § 23(p)(1) and Reg. 111, § 29.23(p)-11; see *Draper & Co.*, 5 T.C. 822, 841 (1945).

[8] § 218(a); 1954 IRC § 421; 1939 IRC § 130A.

[9] 1954 IRC § 421(a)(2); 1939 IRC § 130A(a)(2).

[10] The company may have no deduction even though the executive has income subject to ordinary tax as compensation by reason of an 85 per cent to 95 per cent option. See 1954 IRC § 421(b). However, if the executive is subject to ordinary income tax because he does not observe the statutory holding periods, the company may have a deduction for any profit realized by the executive upon his exercise or sale of the option. Consult 1954 IRC § 421(f); I.T. 3795, 1946-1 C.B. 15.

Apart from seeking to meet its tax needs, the company will usually seek a plan that serves to retain executives by making benefits contingent upon continued performance. Other company objectives may be (1) to offer incentives to improve the company's profits, capital position, dividends; (2) to postpone compensation as a form of guaranty of desired behavior, e.g., not entering the employment of a competitor; (3) to stimulate employees to become executives and seek promotion; (4) to encourage retirement in order to make way for younger executives.

3. The Executive's Tax Needs

The financial problems of the executive over the past decade have received judicial recognition. In the course of an opinion upholding the corporate power of the Republic Steel Corporation to grant a pension to Tom Girdler, as chairman of its board of directors, the court said:

> There are many demands made upon the executive in the performance of his duties which tax his financial resources. Also in recent years the executive has carried a very heavy tax burden, one which is greatly lessening his opportunity to amass great riches.[12]

While this opinion was rendered a number of years ago, the problems of the executive mentioned by the court are at least as serious to-day. Table 22-1 shows the salary, after 1953 federal income taxes, of a married executive without dependents.[13]

TABLE 22-1

SALARY	SALARY AFTER TAX	PER CENT OF SALARY PAID OUT IN TAXES
$ 20,000	$14,924	25.38
30,000	20,584	31.38
40,000	25,066	37.34
60,000	32,122	46.46
100,000	43,818	56.18

If an executive or his wife has outside income, his salary income will, of course, be worth less.

The loss in the dollar's purchasing power has affected all employees, but has perhaps affected executives as a group more seriously than others. This is because salary increases to make up for loss in purchasing power result in progressively higher rates of tax. Table 22-2 shows a computation of the 1953 salary needed, by a married executive without dependents, to make up for his loss in purchasing power since 1939.[14]

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[11] See *Kaufman* v. *Schoenberg* (Del. Ch. 1952), 91 Atl. 2nd 786, 795, citing Washington and Rothschild, footnote 3, above, at page 167.

[12] *Holmes* v. *Republic Steel Corp.* (Ohio Com. Pleas 1946), 69 N.E. 2d 396, 410, modified and affirmed, 84 Ohio App. 442, 84 N.E. 2d 508 (1948).

[13] William J. Casey and J. K. Lasser, *Executive Pay Plans,* page 1. New York; Business Reports, Inc., rev. 1952. The standard deduction is used.

TABLE 22-2

1939 SALARY	REQUIRED SALARY IN 1953
$ 20,000	$ 61,000
30,000	140,000
40,000	220,000
60,000	580,000
100,000	1,000,000

The figures in the second column represent no increase in real salary despite over a decade of service and experience. Moreover, they do not take into consideration state income taxes, which may require still larger present-day compensation to match 1939 salary.

Some reduction in federal income taxes is taking place, but nevertheless the salary income of few top and middle level executives has increased sufficiently to enable them to earn the same real salary as in 1939. One survey of 14 large companies showed clearly the discrepancy between dollar increases and real salary changes from 1939 to 1950 reflected in Table 22-3.[15]

TABLE 22-3

	AVERAGE PAY		PER CENT INCREASE	1950 PAY AFTER TAXES AND INFLATION	REAL CHANGE
	1939	1950			
Top management (highest paid 1% of total employees)	$43,700	$59,300	+35%	$18,000	−59%
Middle management (next 9%)	10,500	15,200	+45%	6,300	−40%
Bottom supervision level (foremen or equivalent)	3,000	5,500	+83%	2,600	−13%
Labor (salaried and hourly employees covered by wage and hour law—includes white collar)	1,650	3,400	+106%	1,700	+3%

The compensation of an executive represents in large part something akin to a return of capital. An executive lives by selling his services and his income reaches a peak during a limited number of years. Under traditional ideas of thrift, those earnings should in good part be put aside to provide security for the future. But circumstances to-day make that difficult.

Until the age of forty or forty-five, the executive's rewards, though they may be far from insignificant, may in good part be consumed by the expense of raising a family. When the executive does reach top rank in his company, he may find that high taxes, taken together with the expenses connected with his position, will prevent any considerable amount of saving. Considering only the effect of taxes, Table 22-4 shows the amount of savings a fifty-year-old executive must acquire to have an income at sixty-five equal to half of his salary after taxes.[16]

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[14] Casey and Lasser, footnote 13, above, at page 2.

[15] Edward C. Bursk, "Thinking Ahead," *Harvard Business Review*, March-April, 1952, page 141. Real wages of hourly paid workers were up 6%; *Patton*, footnote 2, above. See Rothschild, "The 'Inflationary' Lag in Executive Compensation," *Personnel Magazine*, July, 1952, pages 25, 26.

TABLE 22-4

SALARY	SAVINGS REQUIRED	PER CENT OF SAVINGS FROM SALARY AFTER TAXES
$ 25,000	$ 8,700	46.4
50,000	14,500	46.6
75,000	18,850	46.5
100,000	22,300	46.3

A more detailed breakdown is given in Table 22-5, which shows the percentage of take-home pay, after 1953 federal income taxes, that must be saved to buy an annuity at age sixty-five equal to about half of net salary, after taxes, on retirement.[17]

From this table it would appear that if an executive secures a 3% return on his savings, he must save from 21% to 41% of his after-tax salary annually, and if he is able to secure a 5% return on his savings, he must save from 17% to 40% of that salary, depending upon the age when effective savings begin. With to-day's high living costs, it is unlikely that many executives succeed in saving so large a percentage of their take-home pay.

This is, of course, one side of the picture. The other side is reflected in the view that in the past, and particularly in the 1920's and 1930's,[18] management's compensation was unduly high. It is implicit in this view that the tax-inflation factor has simply brought about a proper and needed readjustment and that, in fact, in some instances still further readjustment is needed.[19] It is also critically suggested that options and supplemental benefits received by management have more than made up for loss in real salary.[20]

Whatever the merits of this dispute, the executive today will often seek from his company benefits differing from the conventional forms of salary and cash bonus of the past, so that he and his family may be provided with the security that he now finds it difficult to attain through his own personal savings. His efforts may have one or more of the following three objectives:

To obtain benefits that are not taxable to him at all;

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[16] Casey and Lasser, footnote 13, above, page 4.

[17] Hall, footnote 2, above, pages 148, 149.

[18] Washington and Rothschild, footnote 3, above, at pages 6, 8. See Rothschild, "The 'Inflationary' Lag in Executive Compensation," footnote 15, above.

[19] *E.g.* Lewis D. and John J. Gilbert, *Thirteenth Annual Report of Stockholders' Activities at Corporation Meetings, 1952*, at pages 41, ff. The Messrs. Gilbert propose ceilings upon compensation and, in particular, upon bonuses.

[20] Westbrook Pegler has written a series of columns attacking "the greedy executive pension racket, the stock-option racket and other grabs of money which should belong to the individual owners of corporation stocks." See N.Y. *Journal American*, May 12, May 13, May 14, May 23, 1953.

Table 22-5

Total and Annual Self-Pensioning Requirements for Executives with Differing Earnings

	(1) Assumed Annual Earnings	(2) Federal Income Tax—1952 Rates§	(3) Net Earnings After Income Tax (Col. 1 — Col. 2)	(4) Desired Annual Retirement Income Payable from Age 65	(5) Fund Which Must Be Accumulated at Age 65 to Purchase Annuity in Column (4) on 10-Year Certain Basis	(6) Approximate Net Rate of Yield (After Allowing for Income Tax on Earnings of Fund) if Fund Earns		(7) Annual Savings Required to Accumulate Fund Shown in Column (5) at Net Yield Rate Shown in Column (6) Where Fund Earns		(8) Annual Savings as % of Net Earnings After Income Tax Where Fund Earns	
						3% Return	5% Return	3% Return	5% Return	3% Return	5% Return
Illustration A*											
40-65..........	$10,000	$ 1,823	$ 8,177	$ 4,000	$ 57,282	2¼%	3¾%	$ 1,732	1,422	21.2%	17.4%
Illustration B†											
40-44..........	10,000	1,823	8,177	4,000	57,282	2¼	3¾	1,732	1,422	21.2	17.4
45-49..........	15,000	3,304	11,696	6,000	85,923	2	3¼	2,982	2,590	25.5	22.1
50-54..........	20,000	5,076	14,924	7,000	100,243	1⅞	3⅛	3,882	3,412	26.0	22.9
55-65..........	25,000	6,983	18,017	9,000	128,884	1¾	2⅞	6,615	6,093	36.7	33.8
Illustration C‡											
40-44..........	10,000	1,823	8,177	4,000	57,282	2¼	3¾	1,732	1,422	21.2	17.4
45-49..........	20,000	5,076	14,924	7,000	100,243	1⅞	3⅛	3,630	3,162	24.3	21.2
50-54..........	30,000	9,176	20,824	10,000	143,205	1½	2⅝	6,427	5,813	30.9	27.9
55-65..........	50,000	20,230	29,770	14,000	200,487	1	1¾	12,393	11,932	41.6	40.1

* Illustration A assumes annual earnings of $10,000 from the ages of 40 to 65.

† Illustration B assumes earnings of $10,000 at the age of 40 and salary increases of $5,000 at the end of each of four 5-year periods, ending with salary of $25,000 annually.

‡ Illustration C is similar to Illustration B except that increases of $10,000 are assumed.

§ Assumes married man, no dependents: 10% deductions on income up to $10,000; $1,000 deductions on income between $10,000 and $20,000; 5% allowable deductions on higher income.

To obtain benefits taxable at capital gain rather than ordinary income rates;

To spread his benefits over future years.

Methods of accomplishing each of these objectives will now be mentioned briefly.

4. How to Provide Benefits That Are Not Taxable to the Executive

Benefits which under given circumstances may not be taxable to the executive include (a) expense allowances, (b) "perquisites," (c) group insurance.

a. Expense allowances. An executive who has attained a sufficiently high rank in his company may find it necessary to do a considerable amount of entertaining and to maintain his position by large expenditures in other ways. To the extent that such expenditures represent "ordinary and necessary" business expenses of his employer[21] and are "reasonable" in amount,[22] the executive may be paid or reimbursed by his employer; such payment or reimbursement will not constitute taxable income to the executive and will be a proper corporate tax deduction. To the extent that such expenditures are personal to the executive, payment or reimbursement constitutes taxable income and may not be deductible by the company.[23]

The line between business and personal expenses of the executive may become quite thin and the location of the line in such matters as payment of an executive's club dues has been subject to conflicting viewpoints.[24] At one time, many executives paid such expenses as a matter of course without concerning themselves too much about arrangements for payment or reimbursement from their employer. Today there is an increasing trend, because of the substantial tax saving represented,[25] for the employing company to pay more and more of such items. This trend is subject to criticism.[26]

Methods of paying or reimbursing expenses incurred by executives will vary from company to company but may be divided into three general categories:

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[21] 1954 IRC § 162; 1939 IRC § 23(a)(1)(A). See Brady A. Bryson, *Tax Aspects of Executives' Compensation*, page 16. New York: Practising Law Institute, rev. 1953.

[22] *Lincoln Electric Co.* v. *Commissioner* (7 Cir. 1949), 176 F. 2d 815, cert. den. 338 U.S. 949 (1950). See also *Rodgers Dairy Co.*, 14 T.C. 66 (1950). *Cf. Botany Worsted Mills* v. *United States*, 278 U.S. 282 (1929); *Limericks, Inc.* v. *Commissioner* (5 Cir. 1948), 165 F. 2d, 483.

[23] A company's payment or reimbursement of an executive's personal expenses (for example, the company's payment of rent for an apartment used by the executive for his own personal purposes) would appear to be tantamount to additional compensation taxable to the executive and deductible by the company. As a practical matter, however, field agents have been disallowing the deduction, in the case of publicly held companies, of items of this nature without seeking to tax the executive upon the company's payments. Their position appears to be simply that the payments are not normal or necessary expenses of the corporate business. *Cf. P. S. Thorsen & Co.*, 15 B.T.A. 1281 (1929); *Donald V. Smith*, 6 T.C.M. 548, 561 (1947). At least in a period of excess profit taxes, when the corporation's tax bracket is higher than that of the executive, this procedure may yield greater revenue.

[24] See Stuart, "Social Club Dues and Expenses," *Tax Magazine*, January 1953, Vol. 31, page 69.

[25] See Casey and Lasser, footnote 13, above, at pages 6-7.

[26] Rothschild, footnote 15, above, page 31; *cf.* John K. Jessup, "How British Businessmen Keep Going," *Fortune Magazine*, May 1950, at page 85.

1. The flat allowance, in accordance with which the executive is granted a specific annual sum for entertainment or other expenditures without the requirement of an accounting to the company, has been popular in the motion picture and one or two other industries and is occasionally used outside such industries but usually for not more than one or two top executives.[27] Tax-wise, the payments made to the executive must be treated in much the same way as salary, with the executive being required to include the payments in his gross income.[28] The principal tax advantage to the executive of the flat expense allowance as against salary is that the allowance constitutes recognition by the company that the executive is expected to pay expenses of the company, and the fact of the allowance will therefore be of some assistance to the executive in establishing his own tax deductions for the entertainment or other expenditures to defray which the allowance was granted.[29]

2. Of greater advantage to the executive from a tax point of view is the allowance for designated expenses upon an appropriate accounting by the executive. Typically, the executive will be granted an allowance, for a designated purpose or purposes, not in excess of a specific figure upon a monthly or other periodic basis, payment to be made by the company upon the production of proper bills or vouchers.[30] The amounts so paid or reimbursed to the executive, in respect of which he has properly accounted, need not be reported by him as gross income and are deductible by the employer.[31] However, since the executive is required to account before he is entitled to reimbursement, the executive will of course not have the same assurance that he will receive his entire expense allowance from the company as he would in the case of the flat expense allowance to which he is entitled without an accounting. Moreover, if the executive's actual expenses in a given period exceed his expense allowance for the period, the executive may have difficulty in establishing the deductibility of the excess on his own tax return.

3. A third general category of expense allowance is one involving simple payment or reimbursement of the executive's expenses of a given nature as and when they are incurred and without the mention of any specific figure. The allowance may be expressly provided for or may be left a matter of company practice or oral understanding. Travelling expense is often handled in this manner.[32] From

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[27] Compare *Burlington Mills Corp.*, Contract with J. Spencer Love dated June 19, 1946, set forth in Washington and Rothschild, footnote 3, above, Appendix I, page 442, with its contract with Herbert M. Kaiser dated December 14, 1949, set forth in Washington and Rothschild, Appendix E, page 436. See *Loew's Inc.*, Contract with Louis B. Mayer, set forth in William J. Casey and V. Henry Rothschild, *Pay Contracts with Key Men*, Exhibit 167, p. 197. New York: Business Reports, 1953; *Panhandle Producing and Refining Co.*, Contract with Roger Gilbert, set forth in Casey and Rothschild, Exhibit 168, page 197.

[28] Reg. 118, § 39.23(a)-2(b); *Ned Wayburn*, 32 B.T.A. 813 (1935); *Victor Cooper*, 8 T.C.M. 689, 697 (1949) aff'd (3 Cir. 1950) 184 F. 2d 514. An expense allowance of this nature must be reported by the company in its information returns. Reg. 118, § 39.147-2.

[29] *Julian A. Martin*, 11 T.C.M. 946, 950 (1952); *cf. Hess Brothers*, 7 B.T.A. 729, 732 (1927); *Eitingon-Schild Co.*, 21 B.T.A. 1163 (1931).

[30] See form contract set forth in Washington and Rothschild, footnote 3, above, at page 27.

[31] *Julius Forstmann*, 6 B.T.A. 21 (1927); *Eitingon-Schild Co.*, footnote 29, above, at 1176.

[32] *Cf. Universal Pictures Co., Inc.*, Contract with William A. Scully, set forth in Washington and Rothschild, footnote 3, above, Appendix K, page 446, providing for payment of travelling expenses of the executive's wife as well as of the executive. Payment of the latter's expenses may be considered taxable compensation to the executive.

a tax point of view, this type of allowance will usually create less problems for both executive and company than the other two general categories.

In the absence of a specific expense allowance, executives who are expected to pay entertainment or other business expenses of their company out of their salary or commissions can be assisted in establishing the propriety of tax deductions for such expenses by an appropriate contractual provision to the effect that their salary has been fixed with a view towards their paying expenses of this nature themselves.[33] Use of such a clause for an executive who is a controlling stockholder of a closely held company may present problems, however, for the clause may be held an admission that the salary was itself not "reasonable" compensation.

In fact, the use of any form of expense allowance for executives who are controlling stockholders of closely held companies will rarely be desirable. Such an executive will usually be better advised to have the company pay directly proper corporate expense incurred by him.

The subject of expenses is discussed at greater length in other chapters in this book.

b. "Perquisites." According to Webster's dictionary, the word "perquisite" derives from a Latin or French word meaning "to ask for diligently" and is defined as "a gain or profit incidentally made from employment in addition to regular salary." We usually think of a perquisite as a specific benefit enjoyed by reason of a particular position or employment.

Perquisites are closely related to expense allowances and may similarly represent a tax-free benefit to the executive, the cost of which is deductible by his employer. For example, a designated executive or executives may be granted the use of a company automobile or airplane or of an apartment or residence owned or maintained by the company. If the executive's use of such a facility is "for the convenience of the employer" and the executive is required to use the facility as a condition of employment, the value of such use will not constitute taxable compensation to the executive,[34] unless the facility was made available as additional compensation.[35]

Other perquisites include provisions for vacations, absence because of disability or illness, and the like.

There has been an increasing trend, particularly in larger companies, towards the use of perquisites such as dining-room facilities with food furnished free or at cost, free recreational facilities, free medical examinations and medical care, special training and educational courses. Although it is conceivable that such perquisites might, at least if abused, present tax problems for the employee or the company or both, no specific tax challenge to such practices appears as yet to have been reported. On the contrary, fringe benefits of this nature have been receiving encouraging treatment.[36]

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[33] *Pepsi-Cola Co.*, Contract with Alfred N. Steel, set forth in Casey and Rothschild, footnote 27, above, Exhibit 165, page 196. See Washington and Rothschild, footnote 3, above, page 30, note 25. Reimbursement for travelling expense must theoretically be reported as income and may then be deducted by the executive upon his own return. Reg. 111, § 29.23(a)(2); 1954 IRC § 62(B), (C), (D); 1939 IRC § 22(n)(2). But *cf. J. S. Cullinan*, 5 B.T.A. 996, 999 (1927); *Jay N. Darling*, 4 B.T.A. 499, 503 (1926), G.C.M. 18430, 1937-1 C.B. 137. There has been no withholding requirement for travelling expense. Reg. 111, § 405.101 (1943).

[34] 1954 IRC § 119, in substance codifying Reg. 111, § 29.22(a)-3. Consult *Olin O. Ellis*, 6 T.C. 138 (1946) (acq.), overruling *Ralph Kitchen*, 11 B.T.A. 855 (1928).

[35] Mim. 6472, C.B. 1950-1, page 15. Consult Norwood B. Orrick, "Compensation to Stockholder Employees," *American University Tax Institute Lectures, Current Issues in Federal Taxation*, Vol. 4, pages 145, 152-5 (1952). Under the new statute, the terms of the employment contract are not conclusive. 1954 IRC § 119.

c. Group insurance. The purchase by a company of an individual policy of insurance upon the life of an employee will usually involve taxable compensation to the employee, unless the company is the owner and beneficiary of the policy.[37] The employee will be taxed upon the premiums paid by the company as and when they are paid, and the premiums will constitute a tax deduction by the company provided that, when added to all other compensation paid the employee, they do not exceed "reasonable" compensation.[38]

The same rule applies to the purchase of an annuity for the employee, unless the purchase is made under a qualified employees' trust or annuity plan.[39] In the absence of such a plan, the executive will not be taxed upon the premiums if his interest in the annuity is forfeitable,[40] but in such a case the company will forfeit its tax deduction.[41]

The rules relating to individual insurance policies and annuities do not apply to certain categories of group insurance. The growth of group insurance plans as a form of executive compensation that is both tax-free to the executive and deductible by the company represents a significant and continuing development.

Life insurance. Employees covered by group term insurance are at present not subject to federal income tax upon either premiums or benefits under such policies.[42] Rulings to that effect, however, do not apply to ordinary or group permanent life insurance, or to the cost of life insurance in retirement plans.[43] A New York statute, followed as a matter of practice by insurance companies in other states, formerly limited the total amount of individual insurance under group policies to $20,000.[44] This limitation has been removed,[45] but model legislation is being proposed to place a new ceiling upon individual policies of $40,000 or the equivalent of two years' salary, whichever is the lower.

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[36] *Slaymaker Lock Co.*, 18 T.C. 1001 (1952) (company expenditures for purchase and improvement of farm land and house conveyed to foremen's union for the recreation of all employees held a reasonable and necessary expense deductible in years made) (acq.) rev'd on other grounds (3 Cir. 1954) 208 F. 2d 313; Rev. Rul. 160, C.B. 1953-2 (company contributions to employees' hospital association for construction of a hospital for company employees held ordinary and necessary expenses). *Cf.* Rev. Rul. 131, C.B. 1953-2 (company aid to employee tornado victims not taxable income to them and deductible by company); *T. J. Moss Tie Co.*, 18 T.C. 188 (1952), petition to review dismissed (8 Cir. 1953), 201 F. 2d 512 (company contributions to trust for assistance of needy employees proper charitable deductions).

[37] O.D. 627, 3 C.B. 104 (1920); *George Matthew Adams*, 18 B.T.A. 381 (1929); *N. Loring Danforth*, 18 B.T.A. 1221 (1930). *Cf. Canaday* v. *Guittean* (6 Cir. 1936), 86 F. 2d 303. See discussion in Bryson, footnote 21, above, pages 22-3, referring to similar tax consequences when ordinary life insurance is part of a pension trust arrangement. Reg. 111, § 29.165-6.

[38] *Berizzi Brothers Co.*, 16 B.T.A. 1307 (1929); G.C.M. 8432, IX-2 C.B. 114 (1930). See *Brown Agency, Inc.*, 21 B.T.A. 1111 (1931).

[39] *Richard R. Deupree*, 1 T.C. 113 (1942); *Renton K. Brodie*, 1 T.C. 275 (1942); *Hackett* v. *Commissioner* (1 Cir. 1946), 159 F. 2d 121; *Ward v. Commissioner* (2 Cir. 1947), 159 F. 2d 502. As distinguished from annuities purchased pursuant to a qualified employees' trust, an individual annuity purchased by an employer for an employee will be deemed to have been purchased by the employee for Federal estate tax purposes. 1954 IRC § 2039.

[40] Reg. 111, § 29.22(b)(2)-5. *Cf.* 1954 IRC § 403(b); 1939 IRC § 22(b)(2)(B). The assignment of an annuity to an employee has been held to result in its taxability to the employee in the year of assignment, although prior thereto the annuity had been owned and payable to the company and the employee had no interest therein. *Elliott C. Morse*, 17 T.C. 1244 (1952), affirmed (2 Cir. 1953), 202 F. 2d 69. *Cf. F. E. Card*, 20 T.C. 620 (1953) (surrender of policy).

[41] 1954 IRC 404(a)(5); 1939 IRC § 23(p)(1)(D). See discussion in Washington and Rothschild, footnote 3, above, pages 233-4 and pages 209-211.

[42] Reg. 111, § 29.22(a)-3; L.O. 1014, 2 C.B. 88 (1920).

Such group policies may include double indemnity provisions in case of accidental death, and insurance against dismemberment. No specific ruling concerning these additional benefits has been published, but their tax status would appear to be similar to the tax status of the life insurance features of group term.

Disability and medical benefits. Group disability represents another increasingly popular form of group insurance. For example, Ford Motor Company has a plan providing for payment, after three months of total and continuous disability, of one-third of salary up to $10,000 a year, continuing for ten years if the disability is due to sickness and until age 65 if due to accident.

Group insurance against catastrophic illness is a relatively new variation of employee insurance benefit. Several insurance companies are issuing policies providing for reimbursement of hospital and medical payments up to a figure of $5,000 to $7,500 per employee for each accident or illness. Such policies usually have co-insurance clauses requiring the employee to pay a percentage, say 20% to 25%, or a minimum of, perhaps, $100 to $250 or so, of his medical costs, with the insurance company paying or reimbursing the balance.

A number of companies offer their employees, including their executives, hospital and medical benefits with the Blue Cross Plan, the Blue Shield Plan, the Hospital Insurance Plan of Greater New York, or special plans offered by insurance companies.

These plans often provide benefits not only for the employee but for the employee's family as well. In granting the employee insurance protection that he would otherwise purchase himself entirely at his own expense and usually at substantially greater cost (when purchased on an individual rather than group basis), such plans offer undeniably important benefits.

An important fillip to such plans has been given by the 1954 Internal Revenue Code, which specifically renders tax-free to an employee the following benefits received by the employee (as well as premiums or other contributions paid by the employer to secure such benefits), irrespective of whether the payments are made by an employer or by an insurance company under a regularly established plan:[46]

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[43] Mim. 6477, 1950-1 C.B. 16.

[44] N.Y. Insurance Law, § 204.

[45] N.Y. Laws 1952, Chapter 117.

[46] 1954 IRC §§ 105, 106. Prior to the 1954 Code, a regularly established and insured plan was needed to assure tax-free status of benefits. I.T. 4107, 1952-2 C.B. 73, modifying I.T. 4000, 1950-1 C.B. 21. Consult 1939 IRC § 22(b) (5); Rev. Rul. 103, 1953-1 C.B. 20; Reg. 116, § 405.101. But *cf. Epmeier* v. *U.S.* (7 Cir. 1952), 199 F. 2d 508. The Commissioner had stated that he would not follow the *Epmeier* case. B.I.R. Release dated March 26, 1953, 5 C.C.H. ¶ 6136 (1953). Consult Rev. Rul. 130, 1953-2 C.B. 99 (employee contributions under New York Disability Benefits law assumed by employer are not taxable income to employer); Rev. Rul. 131, footnote 36, above.

1. Amounts paid or reimbursed for medical care of the employee and for the spouse and dependents of the employee as well;
2. Amounts paid to compensate for loss of a bodily member or function, or for disfigurement, of either the employee or the employee's spouse or dependents;
3. Amounts paid in lieu of salary during absence from employment because of injury or illness, up to a maximum of $100 a week after the first week, unless the absence is due to injury (as distinguished from sickness) or unless hospitalization takes place during the period, in either of which events tax-free status attaches to the amounts attributed to the first week as well.

To secure these tax benefits, there is no requirement of a non-discriminatory general plan, and presumably the benefits in question may be confined to a designated executive or group of executives.

5. How to Provide Benefits That Are Taxable to the Executive at Capital Gain Rather Than Ordinary Income Rates

An employee may be put in a position to receive benefits taxable at capital gain rather than ordinary income rates by being given the opportunity of acquiring shares of capital stock, warrants, or other capital assets. The principal methods by which this opportunity may be conferred include (a) the stock bonus, (b) the bargain purchase, (c) purchases through credits or installment payments, (d) the stock option and (e) management stock plans. The acquisition of stock on behalf of employees by a trust qualified under Section 401 of the Internal Revenue Code is discussed in other chapters in this book.

It should be observed that transactions involving stock or other assets do not necessarily involve compensation simply because they take place as between employer and employee. Congress[47] and the courts[48] have recognized that stock options and other stock transactions between a company and its employees may under given circumstances be "proprietary" rather than compensatory in nature and that stock transactions may or may not involve compensation.

Tax questions incident to employee stock transactions are discussed at length elsewhere in this book. In addition to tax questions, stock transactions may require consideration of questions relating, among other things, to corporate powers,[49] to preemptive rights,[50] to application of employee purchase plan statutes,[51] to registration, and other problems under the Securities Act of 1953 and stock exchange regulations,[52] to short-swing profits under Section 16(b) of the Securities and Exchange Act.[53]

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[47] Senate Report No. 2375 (Aug. 22, 1950), 81st Cong., 2nd Sess. U.S.C. Cong. Serv. p. 3053; *cf.* H.R. Rep. No. 2087, 80th Cong., 2d Sess. (1948) to accompany H.R. No. 6712, at page 5. See also H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954) to accompany H.R. 8300, at page 45.

[48] *Norman G. Nicolson*, 13 T.C. 690 (1949); *James M. Lamond*, 5 T.C.M. 51 (1946); *Delbert B. Geeseman*, 38 B.T.A. 258 (1938) and cases cited in footnotes 67 and 70, below. See also cases cited in Washington and Rothschild, footnote 3, above, page 130, note 40.

[49] Washington and Rothschild, footnote 3, above, at pages 123-4.

[50] See Washington and Rothschild, footnote 3, above, at pages 124, ff.

[51] *Id.*, page 126.

[52] *Id.*, pages 333, ff. See *Securities and Exchange Commission* v. *Ralston Purina Co.*, 346 U.S. 119 (1953).

[53] Washington and Rothschild, footnote 3, above, at 357, ff.

Stock transactions between company and employee have been the subject of a series of attacks by minority stockholders based on absence of consideration.[54] The resulting decisions appear to leave the door open to an attack upon real or paper profits from such stock transactions upon the ground of "unreasonable compensation." [55] But to view such payments as compensation is to overlook the investment or "proprietary" aspects of these transactions; a similar view adopted by the Treasury Department was rejected by Congress.[56] At least a partial solution to the problem has been adopted in Delaware through statute rendering conclusive the judgment of the board of directors as to the consideration for an option and its sufficiency.[57]

a. The stock bonus. Many companies have in the past made a practice of paying profit-sharing or other bonuses with stock of the company or of an affiliate, in order to grant executives an investment interest in the company and perhaps to conserve the company's cash resources. When the stock that is the subject of the bonus has a readily ascertainable market value, the stock bonus presents no particular tax problems. The executive, on receipt of the stock, is deemed to have received taxable compensation equal to the fair market value of the stock.[58] The company has a tax deduction equal to the fair market value of the stock,[59] subject to the usual requirement that total compensation, including the bonus, does not exceed reasonable compensation. In addition, unless the stock that is the subject of the bonus is being issued for the first time by the company, the company may also have a profit or loss for tax purposes, depending upon the cost of the stock to the company.[60]

To avoid market value questions, a stock bonus will often be declared as a cash bonus, with a provision that the cash bonus shall be paid in stock, converting cash into shares of stock at current value or some other price or formula fixed in advance.[61] Restrictions affecting the sale or disposition of the stock may destroy or impair its market value and may result in avoidance or reduction of a tax upon its receipt,[62] a subject discussed further below.

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[54] See *Kerbs* v. *California Eastern Airways, Inc.* (Sup. Ct. Del. 1952), 90 A. 2d 652, reargument denied, 91 A. 2d 62; *Gottlieb* v. *Heyden Chemical Corp.* (Sup. Ct. Del. 1952), 90 A. 2d 660, reargument denied, 91 A. 2d 57 and 92 A. 2d 594; *Eliasberg* v. *Standard Oil Co.* (N.J. Super. Ct. 1952), 92 A. 2d 862, affirmed (1953) 97 A. 2d 437; *Kaufman* v. *Schoenberg* (Del. Ch. 1952), 91 A. 2d 786.

[55] The cases cited in footnote 54, above, all suggest in one way or another that consideration for an option must have a value reasonably related to the value of the option, with *Rogers* v. *Hill* 289 U.S. 582 (1933) cited or in mind. See *Gottlieb* v. *Heyden Chemical Corp.*, 92 A. 2d 594 at 599.

[56] See footnotes 47, 67 and 70, and connected text.

[57] Del. Gen. Corp. L. Tit. 8, § 157, as amended by Del. Ls. ch. 315 (July 8, 1953). See Business Week, August 8, 1953, for statutory background. *Cf.* Mont. Rev. Code 15-801, § 39, 10(B), amended, L. 1953, c. 46; N.Y. Stock Corp. L. § 69, amended, L. 1954, c. 799, § 1.

[58] Reg. 111, § 29.22(a)-3; *Old Colony Trust Co.* v. *Comm.* (1 Cir. 1932), 59 F. 2d 168.

[59] *Package Machinery Co.* 28 B.T.A. 980 (1933); *Alger-Sullivan Lumber Co.* v. *Commissioner* (5 Cir. 1932), 57 F. 2d 3.

[60] *Commissioner* v. *Batten, Barton, Durstine & Osborne*, 171 F. 2d 474 (2 Cir. 1949), cert. den. 338 U.S. 816 (1949); *International F. Corp.* v. *Commissioner* (2 Cir. 1943), 135 F. 2d 310; *Helvering* v. *Edison Bros. Stores* (8 Cir. 1943), 133 F. 2d 575 cert. den. 319 U.S. 752.

[61] *E.g.* Monsanto Chemical Co. Incentive Compensation Plan, set forth in Casey and Rothschild, footnote 27, above, Exhibit 155, pages 164, ff. The classic plan is, of course, the General Motors Bonus Plan, first approved by stockholders on August 27, 1918, and amended from time to time thereafter. See Washington and Rothschild, footnote 3, above, Appendix R, page 466. The du Pont Bonus Plans are even more venerable, having been in operation in one form or another since 1904. See Casey and Rothschild, footnote 27, above, Exhibit 157, page 175.

High tax rates have discouraged the current stock bonus; if a substantial block of the bonus stock must be sold to pay the tax upon its receipt, the purpose of the bonus is defeated or impaired. In place of the current stock bonus, companies have adopted stock bonus plans under which a bonus declared in one year is paid out in installments in future years with a requirement that the bonus be "earned out" through services, and with a bonus committee having power to determine how much of the bonus will be paid in cash and how much in stock.[63] Bonuses paid under a properly prepared plan of this nature are taxable to the executive only in the years in which received; they are deductible by the company in the years in which paid.[64]

A variation of the installment stock bonus plan is the plan under which the bonus is not payable until the retirement or termination of employment of the executive to whom it is awarded, at which time the bonus will be paid in annual installments which must be earned out by not engaging in employment with a competitor and possibly, in addition, by rendering consultive and advisory services when called upon to do so.[65]

b. The bargain purchase. By "bargain purchase" is meant an outright purchase of stock at less than market value, as distinguished from a commitment to purchase in installments over a period of time or a right or option to purchase without commitment.

Prior to 1945, the question whether the transfer by an employer to an employee of stock for less than its market value resulted in taxable income to the employee turned principally upon a question of fact. If the transfer at a favorable price was found to be a reward for services rendered or to be rendered, the difference between the market price and the price paid by the employee was taxable as compensation;[66] if the transfer was found to be for the purpose of an investment by the employee, the transaction was not subject to tax until the stock was sold and then any profit was taxed only at capital gain rates.[67]

Following the United States Supreme Court decision in 1945 in the *Smith* case,[68] and the Treasury Regulations issued thereafter,[69] the Commissioner of Internal Revenue took the position that any transfer of stock from an employer to employee at less than its market value involved compensation, and such still appears to be the position of the Commissioner. The Tax Court is apparently not prepared to uphold the Commissioner's position in all cases and seems disposed to continue to recognize the distinction between proprietary or investment transactions on the one hand, and compensatory transactions on the other.[70]

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[62] *Helvering* v. *Salvage*, 297 U.S. 106 (1936). See footnotes 71 and 72, below, and connected text.

[63] *E.g.* Pittson Co. Plan, set forth in Casey and Rothschild, footnote 27, above, Exhibit 156, pages 170, ff. The General Motors and du Pont Plans are of this type. Until 1943, General Motors bonuses to employees earning more than a designated amount were payable entirely in stock.

[64] See *James D. Mooney*, 9 T.C. 713 (1947); *cf. John L. Seymour*, 14 T.C. 1111 (1950). But *cf.* Produce Reporter Co., 18 T.C. 69 (1952), affirmed on other grounds (7 Cir. 1953), 207 F. 2d 586.

[65] American Smelting and Refining Co., Additional Compensation Plan, set forth in Proxy Statement of March 19, 1951 (additional compensation allotments to officers and major executives payable one-third in cash immediately and two-thirds in stock contingently, in 10 to 15 annual installments following termination of employment); *cf.* Van Raalte Company, Inc. Profit-Sharing Plan, set forth in Casey and Rothschild, footnote 27, above, Exhibit 95, page 112.

[66] *K. R. Kingsbury*, 31 B.T.A. 1126 (1935). See cases cited in Washington and Rothschild, footnote 3, above, page 130, note 39.

[67] *Bothwell* v. *Commissioner*, 27 B.T.A. 1351 (1933), affirmed (10 Cir. 1935) 77 F. 2d 35; *Delbert B. Geeseman*, 38 B.T.A. 258 (1938). See Bastedo, "Taxing Employees on Stock 'Purchases,'" *Columbia Law Review*, February 1941, Vol. 41, page 239; see also footnote 48, above, and cases cited in footnote 70, below.

The bargain purchase to-day may offer advantages, particularly for the closely held company, if restrictions upon the sale or disposition of the stock are such as to render the stock non-marketable. A bargain purchase of stock under such circumstances has been held to involve no taxable compensation at the time of purchase[71] and the expiration of the restrictions has been held not to involve a taxable event even though the stock acquired a fair market value when the restrictions were removed.[72] The Commissioner of Internal Revenue has acquiesced in both these decisions.[73] Whether he will take the position that the sale of the stock results in ordinary income remains to be seen.

c. Purchases through credits and installment purchases. Under both the purchase-through-credits and the installment purchase plan, stock of the employing company or of an affiliate is paid for over a period of time. In the purchase-through-credits type of plan, the stock is set aside and paid for by cash bonuses, as and when declared, future dividends, or wage or salary deductions, or some combination of the three; but there is no firm commitment to buy on the part of the employee and the stock is not transferred to the employee until fully paid for. This type of transaction is no longer so popular because it will be considered in effect an option, with a tax on ordinary income imposed on the difference between the market value of the stock and the amount paid for the stock at the time of its transfer to the employee.[74]

In the installment purchase type of transaction, the stock is transferred immediately to the employee, who agrees to pay for it in installments over a period of time, through salary deductions or cash payments, or both, with dividends or dividend equivalents credited against the purchase price. The theory of this type of plan is that the employer is simply extending credit to the employee to permit his purchase of stock, and that the employee is accordingly subject to tax only on any difference between market value and the amount agreed to be paid at the time of the initial transfer of the stock.[75] Depending upon the circumstances in each case, an installment purchase transaction may likewise be held the equivalent of an option, particularly if the employee is given an unqualified right to require the employer to repurchase the stock at the original purchase price.[76] Both the purchase-through-credit and installment purchase types of transaction may be so devised as to meet the requirements of a restricted stock option set forth below.[77]

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[68] *Commissioner* v. *Smith*, 324 U.S. 177 (1945), rehearing denied, 324 U.S. 695 (1945).

[69] Reg. 111, § 29.22(a)-1, as amended by T.D. 5507, 1946-1 C.B. 18. See I.T. 3795, 1946-1 C.B. 15.

[70] *Norman G. Nicolson* and *James H. Lamond*, footnote 48, above; *Malcolm S. Clark*, 9 T.C.M. 719 (1950). *James C. Hazelton*, 12 T.C.M. 398 (1953) app. dismissed (7 Cir. 1953); *Edward Eagan*, 12 T.C.M. 876 (1953); *Donald B. Bradner*, 11 T.C.M. 566 (1952) aff'd (6 Cir. 1954) 209 F. 2d 956; *Martin L. Straus, 2d*, 11 T.C.M. 786 (1952) aff'd (7 Cir. 1954) 208 F. 2d 325. But *cf. Otto C. Schultz*, 17 T.C. 695 (1951) ("option" a substitute for bonus); *Harry A. Gerrish*, 10 T.C.M. 778 (1951); *Ray and Dessie T. Noland*, 12 T.C.M. 1003 (1953) (compensation "intended"). *Cf. Harley* v. *McNamara* (7 Cir. 1954), 210 F. 2d 505 (compensation "intended" to be the spread at time option granted rather than when exercised). For more recent cases, consult *Commissioner* v. *LoBue* (3rd Cir. 1955), 223 F. 2d 367, certiorari granted; *Charles E. Sorensen*, 22 T.C. 321 (1954); *Robert A. Bowen*, 13 T.C.M. 668 (1954); *Commissioner* v. *Straus* (7th Cir. 1953), 208 F. 2d 325; *John C. Wahl*, 19 T.C. 651 (1953).

[71] *Harold H. Kuchman*, 18 T.C. 154 (1952).

[72] *Robert Lehman*, 17 T.C. 652 (1951) app. dismissed (2 Cir. 1952).

[73] 1952-2 C.B. 2 and 1952-1 C.B. 3, respectively. See (Note) 62 *Yale Law Journal* 832 (April, 1953).

[74] *George W. Mason*, 41 B.T.A. 1287 (1940), affirmed (6 Cir. 1942) 125 F. 2d 540, cert. den. 317 U.S. 657 (1952); *Omaha National Bank* v. *Commissioner* (8 Cir. 1935), 75 F. 2d 434.

In connection with installment purchase transactions, statutes prohibiting loans to officers and directors should be considered.[78]

d. The stock option. The federal income tax aspects of so-called restricted stock options, as set forth in Section 421 of the Internal Revenue Code of 1954, are discussed at length elsewhere in this book. Briefly, a restricted stock option will not be taxed upon its grant or upon its exercise, but only upon realization of actual profit upon sale of the option stock, provided the holding periods set forth in the statute are observed. If the term of the option is no longer than ten years (five years in the case of an option to an individual owning over 10% of the voting stock) and the option price was 95% or more of market value at the time the option was granted (110% in the case of an individual owning over 10% of the voting stock), profit upon sale of the option stock will be taxed only at capital gain rates. If the option price was below 95% of such value (but not less than 85%), the spread at the time the option was granted or the actual profit, whichever is less, will be taxed at ordinary income rates, but only on sale of the option stock, with any remaining profit being subject to tax as a capital gain.[79]

With respect to unrestricted stock options not qualifying for the benefits of Section 421, their tax consequences appear to be the same as those incident to a bargain purchase.[80] As with a bargain purchase, the position of the Commissioner of Internal Revenue has been that all unrestricted stock options issued by an employer to an employee involve compensation if there is a spread between market value and option price at the time of exercise of the option; the spread will then be taxed as compensation when the option is exercised.[81]

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[75] For examples of such plans, see Union Carbide and Carbon Corporation Stock Purchase Plan (approved by stockholders on April 14, 1946) and American Home Products Corporation Executives' Stock Purchase Plan (approved by stockholders on April 26, 1950) set forth in Washington and Rothschild, footnote 3, above, Appendix CC, pages 531, ff. and Appendix EE, pages 536, ff., respectively.

[76] Ruling relating to *Federated Department Stores* set forth in Report of Research Institute of America, December 12, 1947, page 9, discussed in Friedman and Silbert, "Stock Option and Stock Purchase Plans," *Proceedings of New York University Eighth Annual Institute on Federal Taxation*, page 433; *cf. William C. Atwater & Co., Inc.*, 10 T.C. 218 (1948).

[77] E.g. "1950 Eastern Airlines Employees Stock Purchase Plan" set forth in proxy statements of April 2, 1951, page 3.

[78] E.g. Del. Gen. Corp. L. tit. 8, § 143; Cal. Gen. Corp. L., § 823, *Cf. Milam* v. *Cooper* Co., 258 S.W. 2d 953 (Tex. Civ. App. 1953) (company loan to president set aside, though not prohibited by statute, because solely for personal advantage of president).

[79] 1954 IRC § 421; 1939 IRC § 130A. For new treatment of so-called variable price options see 1954 IRC § 421(d)(1)(A)(ii). The term limitation of five years in the case of a substantial stockholder does not apply if the option was exercised before August 16, 1955. The term limitation of ten years for other options applies only to options granted after June 18, 1954. 1954 IRC § 421(d)(1)(C) and (D).

[80] See footnotes 66 to 70, above, and connected text.

In one case, involving marketable, fully transferable warrants—legally, very similar to unrestricted stock options—the court rejected the Commissioner's contention that sale of the warrants at a profit resulted in taxable compensation and held that upon the facts taxable compensation was involved only in the issuance of the warrants and that their subsequent disposition at a profit represented a capital gain.[82]

Despite specific statutory benefits conferred on restricted stock options, unrestricted stock options continue to be useful (1) when an option price of less than 85% is to be fixed[83] or when a longer option term than that made a statutory prerequisite is desired, or (2) when an option is to be granted to a company or person associated with the enterprise but not eligible for a restricted option because not an employee—e.g., attorneys, accountants, management consultants, public relations and advertising firms.[84]

The closely held company may have problems with a restricted stock option by reason of difficulties in determining with assurance what will be accepted as fair market value of the option stock for the purpose of qualifying the option for the stock as restricted. These valuation difficulties will be even more serious in the case of an option to a substantial stockholder who does not have the 15% leeway (from 100% to 85%) before losing the tax advantages of a restricted stock option. In the case of such options, when valuation problems are involved, consideration might be given to an option price above the 110% of the price believed to represent fair market value.

The imposition of restrictions upon the option stock when acquired, similar to those mentioned above in connection with bargain purchases,[85] may offer a possible solution to such problems. Since the closely held company has no ready market for its stock, consideration may appropriately be given to buy-back provisions in accordance with which the employing company has the right or, possibly at the employee's election, agrees to repurchase its stock on the employee's death, retirement or termination of employment.[86]

e. Management stock plans. The use of trusts, as in connection with the very successful General Motors and Chrysler management stockholding plans,[87] to acquire stock of the employing company largely with that company's own funds, no longer seems feasible as an incentive device. The corporate or trust entity will apparently be disregarded to tax as ordinary compensation any profits realized by the executive.[88]

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[81] See Treasury Regulations, footnote 69, above; *Harley* v. *McNamara*, footnote 70, above.

[82] *Estate of Lauson Stone* (3 Cir. 1954), 210 F. 2d 33. *Cf. Harley* v. *McNamara*, footnote 70, above.

[83] Or 110% in the case of an individual owning over 10% of voting stock. See footnote 79, above.

[84] 1954 IRC § 421(a)(A); 1939 IRC § 130A(a)(A).

[85] See footnotes 71 and 72, above, and connected text.

[86] Consult *Estate of Raymond T. Marshall*, 20 T.C. 979 (1953) and *Patent Button Co.* v. *Commissioner* (2 Cir. 1953), 203 F. 2d 479. *Cf.* Casey and Rothschild, footnote 27, above, Exhibit 159, page 178 and Exhibit 164, page 191. But such limitations, standing alone, may not always constitute effective limitations of value for tax purposes. *Spitzer* v. *Commissioner* (8 Cir. 1946) 153 F. 2d 967; *Commissioner* v. *McCann* (2 Cir. 1944), 147 F. 2d 385; *Kline* v. *Commissioner* (3 Cir. 1942), 130 F. 2d 742, cert. den. 317 U.S. 697 (1943).

[87] These plans are summarized, and one of the Chrysler plans set forth in full, in Washington and Rothschild, footnote 3, above, pages 113, ff. and Appendix V, page 488.

On the other hand, the creation of a new class of stock of the employing company, with only nominal value, for subscription by designated executives who will be in charge of the new company's business, appears to offer significant possibilities. The executives pay the full value of the stock and any increase in the stock's value will depend upon the success of the company's operations, in turn largely dependent upon the executives' future contributions.[89] The only real tax risk appears to be a possible contention by the Commissioner of Internal Revenue in a given case that the company's expected future earnings based on past performance has resulted in an undervaluation of goodwill and of the actual value of the management stock. This risk may be increased if the management stock is stock of a new company and contracts, orders, or other commitments or contributions, express or implied, of the old company are held to be goodwill of the new company. The creation of new companies on a tax-free basis, with the possibility of having some or all of their stock eventually issued to management employees, has been encouraged by spin-off provisions added to the Internal Revenue Code in 1951.[90]

If management stock is convertible into other stock, the transaction may be considered an option for tax purposes.[91]

6. How to Spread the Executive's Benefits over Future Years

Some of the forms of compensation and incentives that have been discussed have aspects of future or deferred benefits. The proceeds of group insurance paid upon death or disability or illness may be thought of as having such aspects. Any profits of the employee upon stock transactions with his company will likewise constitute future benefits. Stock transactions have the additional advantage of permitting the employee to control the year or years in which future benefits will be realized; if there is a profit, the employee can sell his stock in a year in which other income is small.

Other methods of spreading the executive's benefits over future years are through so-called deferred compensation plans and contracts. These plans may be either funded or unfunded.

a. Funded plans. Most deferred compensation plans that are funded to-day are group pension or profit-sharing plans qualified under Section 401 (or its predecessor, Section 165) of the Internal Revenue Code. The tax advantages conferred upon plans that are so qualified are:

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[88] *Joseph W. Frazer*, 4 T.C. 1152 (1945), affirmed (6 Cir. 1947) 157 F. 2d 282, cert. den. 329 U.S. 807 (1947); *Harry A. Kaufmann*, 9 T.C. 435 (1947) aff'd (6 Cir. 1949) 173 F. 2d 225. A later plan of this general character proposed by Paramount Pictures Inc. was abandoned. See Proxy Statement dated March 14, 1947. It is understood that at the time the plan was abandoned the company had sought but had not obtained a ruling as to tax consequences.

[89] A well-known plan of this nature is that of Vacuum Foods Corp. (now Minute Maid Corp.). See Casey and Rothschild, footnote 27, above, Exhibit 82, pages 73, ff.

[90] 1954 IRC § 355(a); 1939 IRC § 112(b)(11), added to the 1939 Code by § 317(a) of the Revenue Act of 1951.

[91] *United Airlines Inc.* ruling, 4 C.C.H. Fed. Tax Service, No. 8637 (1947).

1. The company's contribution to the plan is deductible as and when made;
2. The employee's benefits under the plan are not taxable unless and until paid;
3. Lump sum payment of benefits made on retirement or termination of employment are taxed only at capital gain rates;
4. Income on funds contributed to the plan is not subject to tax and the entire income can thus be accumulated without depletion by tax;
5. If stock acquired with funds under the plan is distributed in kind, the employee takes the stock at its cost to the plan, pays no tax on any appreciated value of the stock at time of distribution, and will pay only a capital gain tax on any such appreciation if and when he sells the stock.
6. Payments under the plan made by or attributable to contributions of the employer are not subject to the federal estate tax.

These advantages, together with the requirements of qualification to obtain them, are discussed elsewhere in this book. It should be observed, however, that the advantages mentioned are those set forth under federal income tax law and may not necessarily be conferred by state income tax statutes. For example, at the present time, lump sum payments from a qualified plan made to a resident of New York State will be subject to ordinary New York income tax rather than capital gain rates.[92]

Plans of this nature are not primarily an executive type of plan; provision for substantial benefits will often render the plan prohibitively expensive because of the large group that may have to be included to qualify the plan. However, the benefits from such plans are not insignificant[93] and it is sometimes possible either to amend existing plans to provide additional benefits to executives or to supplement such plans with a qualified profit-sharing plan.

The thrift or savings plan under which a company agrees to contribute a percentage of every dollar saved by its employees and placed in a trust for their benefit is a type of funded deferred compensation plan that is becoming increasingly popular. At one time confined to the oil and one or two other industries, its use is being extended to other industries. A thrift or savings plan may be qualified under Section 401 of the Internal Revenue Code of 1954 and the accumulation and reinvestment on a tax-free basis of income from funds contributed under such a qualified plan are undoubtedly attractive features. Such plans also encourage savings for retirement and family security which otherwise may never be made.

Funded plans not qualified under Section 401 of the Internal Revenue Code (or its predecessor, Section 165 of the 1939 Code) have been used rarely. The employee's interest in a trust fund or in insurance or annuities purchased by the company must be vested and non-forfeitable for the company's contribution under the plan to constitute a tax deduction; if the employee's interest is forfeitable, the company may lose its deduction entirely.[94] But if the employee's interest is non-forfeitable, the employee is subject to immediate tax upon his future benefits.[95] Such considerations make funded but non-qualified deferred compensation plans impractical to-day.

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[92] The New York tax law on this point may shortly be changed as the result of a pending study by a governor-appointed commission.

[93] See Top Management Compensation, *Studies in Labor Statistics, No. 8*. New York: National Industrial Conference Board (1953). Consult 1954 IRC § 401(a)(3) and (a)(4); 1939 IRC § 165(a)(3)(A) and (4).

b. Non-funded plans: *Pensions.* A company may, of course, adopt a pension plan that is unfunded in whole or in part. Under such a plan, the company will take a tax deduction for a specific pension as and when it is paid and the employee will pay a tax on the pension as and when it is received.

Pensions of this nature, on a more or less informal basis, were at one time the usual form of retirement arrangement and may still be useful in many situations. However, they present a number of problems, among them the following:

1. If the company commits itself contractually to the pension so that the employee has, upon retirement, an unconditional, legally enforceable obligation to a pension from the company during the remainder of his life or for a period of years, the Commissioner of Internal Revenue, according to some tax thinking, may take the position, in the absence of statute, regulation, or definitive rulings, that the employee is taxable in the year of retirement on the discounted value of all future payments to which he is entitled, just as if he had received a paid-up annuity at that time purchased for him by his company.[96] It is open to question, at least in the case of an employee on a cash rather than accrual basis, whether an unsecured promise of an employer to pay a pension is the equivalent for tax purposes of an annuity or other obligation of a third party transferred by an employer to an employee.[97] It is also open to question whether retirement following the rendition of services upon which a pension is conditioned constitutes a taxable event so as to render taxable at that time the promise of a pension conditional when made on future services.[98] But with the present uncertain state of the law,[99] conservative practice to-day is to avoid a firm commitment to pay an unfunded pension and either to have such a pension simply a matter of company practice or understanding without legal enforceability, or to enter into so-called deferred compensation or future service contracts.

2. The absence of a legal commitment leaves the employee entirely at the

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[94] 1954 IRC § 404(a); 1939 IRC § 23(p)(1); Reg. 111, § 29.23(p)-11. See *Draper & Co.*, 5 T.C. 821, 841 (1945).

[95] *J. H. McEwen*, 6 T.C. 1018 (1946); *D. W. Anderson*, 5 T.C. 1317 (1945); *cf. Rodrigues* v. *Edwards* (2 Cir. 1930), 40 F. 2d 408; *Hackett* v. *Commissioner*, 5 T.C. 1325 (1945), affirmed (1 Cir. 1947), 159 F. 2d 121; *E. T. Sproull*, 16 T.C. 244 (1951), affirmed (6 Cir. 1952), 194 F. 2d 541.

[96] See Eisenstein, "A Case of Deferred Compensation," *Tax Law Review*, 1949, Vol. 4, page 391. *Cf. K. R. Kingsbury*, footnote 66, above; *William E. Freeman*, 4 T.C. 582 (1945) app. dismissed (2 Cir. 1947); *Howard Veit*, 8 T.C. 809 (1947), 8 T.C.M. 919 (1949); *E. T. Sproull*, footnote 95, above.

[97] *Cf. Mertens* v. *Rogan* (9 Cir. 1946), 153 F. 2d 937; *Commissioner* v. *Oates* (7 Cir. 1953), 207 F. 2d 711; *Kay Kimbell*, 41 B.T.A. 940 (1940). See also *Wilfred Weathers*, 12 T.C.M. 314 (1953); *Nina J. Ennis*, 17 T.C. 465 (1951) app. dismissed (6 Cir. 1952); *Shuster* v. *Helvering* (2 Cir. 1941), 121 F. 2d 643.

[98] *Cf. Helvering* v. *Salvage*, footnote 62, above; *Robert Lehman*, footnote 72, above; *Frances Elliott Clark*, 28 B.T.A. 1225 (1933), affirmed (3 Cir. 1935), 77 F. 2d 89.

[99] In connection with the Internal Revenue Code of 1954, the House of Representatives adopted specific provisions, which were rejected by the Senate pending further study of the subject by the Treasury Department. See H.R. 8300, 83d Cong. 2d Sess., §§ 401-403.

mercy of the company throughout his retirement. While many executives would be prepared to forego a legal commitment because of their close association with the board of directors, they run the risk of a change of management, with new officers unfamiliar with the value and extent of past services and perhaps desirous of effecting drastic economies.

3. Even with a legal commitment from his company, the executive must rely entirely on the company's general credit over what may prove to be a long period of years during which he will no longer have any voice in management. From the company's point of view, such a legal commitment may prove a serious financial burden, impair credit and render at least the closely held company unsaleable because of heavy continuing liabilities.[100]

For these and other reasons, both companies and executives may to-day prefer to have pensions funded, at least in part, under a qualified plan. However, unfunded pensions continue to prove useful in a variety of situations. Many smaller and closely held companies have an informal pension practice of an unfunded nature and others adopt pension plans of this nature with the objective of formalizing and funding them gradually over a period of time.

Future service contracts. More and more companies are entering into contracts with individual executives providing for services and commitments on the part of the executives following their retirement from active service and annual payments in consideration thereof for a period of time. The services are generally of a consultive and advisory nature. Usually, the executive will also be precluded from accepting employment with a competing company. The payments to the executive may be made subject to other contingencies, such as the amount of the employing company's profits or the executive's outside earnings.

Retention of the executive for specific purposes following his retirement results (1) in tapering off his services if the tapering off process did not take place prior to retirement; (2) in having the executive available thereafter on a stand-by basis in the event of emergency; (3) in keeping up the executive's morale following the difficult adjustment brought on by retirement. The restriction against competition may be even more important to the company, at least in competitive industries such as the automobile and department store industries. Making the payments contingent upon profits[101] protects the company to some degree in bad times. A provision reducing the payments in terms of the executive's other earnings[102] makes it appear that the payments to him are not for future services and, in addition, may be difficult to enforce. A provision reducing such payments by amounts received by the executive from a qualified pension or profit-sharing plan may also jeopardize the tax status of the qualified plan.

The tax thinking behind provisions making payments to the executive contingent is that since the payments are not unconditional in nature, they will not be regarded as an annuity taxable at discounted value. Assuming the risk behind this thinking to be valid, the conclusion that such conditions obviate the risk will of course depend upon whether the conditions are real or merely colorable.

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[100] *Cf. Mann,* footnote 4, above.

[101] See *American Shipbuilding Co.,* Contract with W. H. Gerhauser, and *Lerner Stores Corporation,* Contract with Russell N. Levin, set forth in Casey and Rothschild, footnote 27, above, Exhibit 104, page 117, and Exhibit 105, page 118, respectively.

[102] *Gimbel Brothers,* set forth in Casey and Rothschild, footnote 27, above, Exhibit 102, page 116.

Payment for future services may be in the form of deferred profit-sharing or stock bonuses contingent upon future services.[103] Such payments, in the form of profit-sharing or otherwise, need not await retirement, and provision may be made for the payments to commence following termination of employment for any reason.[104]

The business problems incident to legally enforceable but unfunded pensions mentioned above likewise apply to future service contracts, which may similarly constitute substantial future liabilities. But, as distinguished from pensions, future service contracts are usually confined to a few selected top executives who are chiefly responsible for policy and management.

c. Death benefits. Death benefits are in many cases a form of deferred compensation. They may be conferred by funded or by non-funded plans or agreements.

To the extent that the employee has a vested or contractual right to such benefits, estate[105] and gift tax[106] problems must be taken into consideration. Applicable state estate tax law must also be considered.[107]

In the past, the usual form of death benefit for an executive was the voluntary continuance by the company of his salary for the benefit of his widow for a period of time. If the period is reasonable, up to, perhaps, two years, the payments constitute a proper tax deduction for the company,[108] unless they are motivated by considerations of charity rather than employee goodwill.[109] Contrary to former ruling,[110] the Commissioner of Internal Revenue now takes the position that such payments will always be taxable to the executive's widow or estate,[111] subject to the $5,000 death benefit exemption hereafter mentioned. His position may not be upheld by the courts.[112]

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[103] See plans cited in footnote 65, above.

[104] *E.g. American Shipbuilding Co.*, Contract with W. H. Gerhauser, footnote 101, above, par. 7.

[105] G.C.M. 27242, 1952-1 C.B. 160; *May D. Hatch*, 14 T.C. 237 (1950), modified and affirmed (2 Cir. 1951), 190 F. 2d 254; *Irene C. Moffett*, 14 T.C. 445 (1950), modified and reversed in part (2 Cir. 1951), 191 F. 2d 149; *Estate of P. G. Leoni*, 7 T.C.M. 759 (1948); *Estate of* A. W. *Davis*, 11 T.C.M. 814 (1952). One case suggests that no estate tax may be involved if the beneficiary is named by a trustee with the employee's right confined to "advice." *Meldrum & Fewsmith, Inc.*, 20 T.C. 790 (1953).

[106] *Estate of William J. Higgs*, 12 T.C. 280 (1949), reversed on other grounds (3 Cir. 1950), 184 F. 2d 427; *Estate of William L. Nevin*, 11 T.C. 59 (1948); Informal Treasury ruling, *Prentice-Hall Pension Trust Service*, No. 1011.

[107] *In re Daniel's Estate*, 159 Ohio St. 109, 111 N.E. 2d 252 (1953) (proceeds of profit-sharing and pension fund payable to employee's widow held subject to Ohio succession tax).

[108] I.T. 3329, 1939-2 C.B. 153; *I. Putnam, Inc.*, 15 T.C. 86 (1950); *Louise K. Aprill*, 13 T.C. 1707 (1949). In keeping with pertinent tax concepts relating to compensation, the propriety of the deduction could well be determined by the reasonableness of the aggregate amount rather than by the mere passage of time. See *Bryson*, footnote 21, above, page 48. See footnote 113, below. Since the above text was written, the Commissioner has ruled that reasonableness of aggregate compensation rather than the length of time during which payments are made will determine deductibility. Rev. Rul. 54-625.

[109] *W. D. Haden Co.*, 5 T.C.M. 250 (1946), modified (5 Cir. 1948), 165 F. 2d 588. *Cf. Dreikorn's Bakery, Inc.*, 7 T.C.M. 276 (1948); *Snyder & Berman, Inc.* (4 Cir. 1941), 116 F. 2d 165.

[110] I.T. 3329, 1939-2 C.B. 153.

[111] I.T. 4027, 1950-2 C.B. 9. *Cf. Estate of O'Daniel* v. *Commissioner* (2 Cir. 1949), 173 F. 2d 966; *Brayton* v. *Welch* (D. Mass. 1941), 39 F. Supp. 537.

If death benefits are paid pursuant to a contract with the executive, the company may take a tax deduction for continuance of salary payments over a substantially longer period than if the payments were voluntary, perhaps throughout the widow's whole life, provided the payments represent reasonable compensation for the executive's past services.[113] Such payments are clearly subject to income tax, again subject to the $5,000 exemption for death benefits.

By specific statutory provision, a total not in excess of $5,000 with respect to the death of any employee may be paid to the spouse or other named beneficiary of the employee free of federal income tax.[114] Such an obligation may be evidenced by specific contract or plan or may be wholly voluntary. The exemption applies to death benefits paid under a qualified employees' pension, profit-sharing or stock bonus trust, even though the employee, prior to his death, had a nonforfeitable right to the benefit, provided that payment is made within one taxable year of the distributee.[115] Except for such trusts, however, the exemption will not apply to an amount to which the employee had a vested right during his lifetime, such as unpaid salary which would have been payable to the employee in any event.[116]

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[112] *Alice M. McFarlane,* 19 T.C. 9 (1952). *Cf. Schall* v. *Commissioner* (5 Cir. 1949), 174 F. 2d 893, with *Mutch* v. *Commissioner* (3 Cir. 1954), 209 F. 2d 390. However, with the $5,000 death benefit now specifically applicable to voluntary as well as contractual payments [1954 IRC § 101(b)(2)(B)], the courts may now find a Congressional intention to tax voluntary payments in excess of $5,000.

[113] Reg. 118, § 39.23(a)-9. See *Mobile Bar Pilots Ass'n,* 35 B.T.A. 12 (1936), reversed on other grounds (5 Cir. 1938), 97 F. 2d 695; *Seavey & Flarsheim Brokerage Co.,* 41 B.T.A. 198 (1940); *H. T. Cushman Mfg. Co.,* 2 T.C.M. 978 (1943); *Bleichroeder, Bing & Co., Inc.,* 12 T.C.M. 117 (1953) (20-year pension to widow).

[114] 1954 IRC § 101(b), 1939 IRC § 22(b)(1)(B), as amended by Section 303 of the Revenue Act of 1951.

[115] 1954 IRC § 101(b)(2)(B).

[116] *Ibid. Cf.* Reg. 111, § 29.22(b)(1)-2, Examples (3) and (5).

23

Compensation to Stockholder-Employees

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Compensation to employees is as "ordinary and necessary" a business expense as one can imagine. At the same time, it has proved to be probably the most productive of controversy of all trade or business expenses deductible in computing taxable income. The magnitude of the body of litigation with respect to deductions for compensation is largely due to those situations where the recipient of the compensation possesses the dual relationship, toward his corporate employer, of employee and substantial stockholder. Compensation paid ordinary corporation employees rarely causes difficulty and the ownership by such an employee of a small portion of his employer's stock is immaterial. On the other hand, in the case of a closely held corporation where officers and key employees are the controlling stockholders, a tax dispute is potentially present. The owners of a profitable corporate business naturally want to enjoy the profits. Just as naturally, they want to avoid as far as possible the double tax on those profits which will result if the latter are paid out in the non-deductible form of dividends on the corporation's stock. The Internal Revenue Code of 1954 has made but a small step toward lightening the double-tax burden by an annual exclusion of $50 of dividend income, and a credit against the stockholder's tax equal to 4 per cent of taxable dividends,[1] such credit in turn being limited to 2 per cent of the taxable income for a taxable year ending before January 1, 1955 and 4 per cent of the taxable income for a taxable year ending after December 31, 1954.[2] Though this may be encouraging in principle as a legislative recognition of an old grievance, from the standpoint of practical relief it will have little effect on the problem under discussion.[3]

Therefore, it is likely that we shall continue to find closely held corporations sometimes distributing earnings in such disguises as rent or interest, and also in the form of excessive compensation, the field with which we are here concerned. Doubtless some instances of excessive compensation are deliberate, or at least reckless, attempts by taxpayers to save taxes, come what may. On the other hand, many cases have much to be said on both sides and not infrequently end in a compromise whereby neither the taxpayer's claimed deduction nor the Commissioner's disallowance is sustained in full.[4]

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[1] 1954 IRC § 116, § 34(a).

[2] 1954 IRC § 34(b).

[3] For example, assume a corporation subject to the 52 per cent combined tax rate (reduced to 47 per cent beginning April 1, 1956 by 1954 IRC § 11(b)) which pays its stockholder $21,200 as annual salary. Assume further that: the deduction of $5,000 of this amount is disallowed as excessive compensation and as being in fact a dividend; that the stockholder is married and files a joint return; that his wife has no income; and that his income from other sources matches his allowable deductions. The corporation will be charged with additional taxes in the amount of $2,600. As against this, the application of the dividend exclusion and dividend credit under the 1954 Code to the $5,000 dividend payment will reduce the individual taxpayer's tax by only $215 from what it would have been had the $5,000 been treated as part of his salary.

It is also to be noted that even though the compensation comes within the category of a deductible business expense, its deduction may be disallowed under section 267(a)(2).[5] As hereinafter discussed, the application of section 267(a)(2) in a given case may depend upon whether or not the employee is also a substantial stockholder.

The fact that an individual is stockholder as well as employee is therefore to be given consideration whenever the matter of compensation arises.

1. Points to Consider

The points to be considered are:

Section
The statutory requirements for deductibility 2
The criteria of reasonableness 3
Deductibility of contingent compensation 4
Tax results of excessive compensation 5
Delaying payment of accrued compensation to stockholder-employee. 1954 IRC sec. 267(a)(2); 1939 IRC sec. 24(c) 6

2. The Statutory Requirements for Deductibility

Section 162(a)(1) of the Internal Revenue Code of 1954, as does section 23(a)(1)(A) of the 1939 Code, lists as one of the ordinary and necessary trade or business expenses, the deduction of which is permitted, "a reasonable allowance for salaries or other compensation for personal services actually rendered."[6] As emphasized by the Regulations: (1) the requirement that the compensation be reasonable in amount is a fundamental one; (2) the payment must be made "purely for services"; (3) the facts behind the payment, and not the form of label attached to it, control the question of deductibility; and (4) the method of fixing the amount of compensation, though frequently important, is not decisive.[7]

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[4] One writer reports that in one hundred Tax Court cases involving deductibility of compensation (decided in a three-year period ending in 1948), the taxpayer prevailed in forty-four, the Commissioner was upheld in twenty-five, and a compromise was determined by the Court in thirty-one. Miriam I. R. Eolis, "Problems in Evaluating the Adequacy of Officers' Salaries," *Proceedings of New York University Seventh Annual Institute on Federal Taxation,* page 39. New York: Matthew Bender and Company, 1949.

[5] 1954 IRC § 267(a)(2); 1939 IRC § 24(c).

[6] The phrase quoted in the text referring specifically to salaries and other compensation first appeared as section 234(a)(1) of the Revenue Act of 1918. It has been pointed out that its origin was a regulation designed to give relief to partnerships and proprietorships under the excess profits tax of 1917 by permitting them an allowance for reasonable compensation even though no such compensation was paid; the effect being to put unincorporated businesses on the same footing as incorporated businesses in this respect. From this, it has been plausibly argued that the phrase is not a restrictive qualification on deductibility of compensation and that by no means was it intended to authorize the Commissioner to police salaries. See Erwin N. Griswold, "New Light on 'a Reasonable Allowance for Salaries,'" *Harvard Law Review,* December 1945, Vol. 59, page 286. In the light of the tremendous body of administrative and litigated precedents to the contrary, this theory, though engaging, must be considered as of academic interest only.

Though the point is unrelated to *stockholder*-employees as distinguished from others, one should remember that the services for which compensation is paid may not qualify for a deduction under section 162(a) because rendered for a purpose which requires the expenditure to be capitalized. For example, the corporation might use its own employees in the construction of a building for its own use. In such case, if the services are not within the scope of the employees' usual duties and if a definite part of their compensation is attributable to these special services, the employer's deduction would have to be realized over a span of years through the allowance for depreciation.[8]

3. The Criteria of Reasonableness

The standard of reasonable compensation is almost as elusive as the concept of the hypothetical reasonable man in the law of torts. It all depends upon the circumstances of the time, the place and the persons concerned. In short, reasonableness is a question of fact.

Though only a narrow aspect of income taxation, the subject of reasonableness of compensation is overladen with decided cases. The frequency of the litigation shows the practical importance of the topic. It also presents the inquirer with a mass of precedents almost overwhelming in its magnitude. Fortunately for the practitioner, admirable efforts have been made in standard treatises to collect and, so far as possible, classify the decisions.[9]

As these compilations demonstrate, there are a number of factors which through recurring application by the courts (including especially the Tax Court) have become familiar criteria in testing the reasonableness of compensation. Hardly ever is any one of these factors controlling, and for any case where one is emphasized another case can be cited where the same factor (or its absence), though noted, is not deemed important because outweighed by others. As one appellate court has stated it, the facts and circumstances vary so widely from case to case, that "each corporate tub must more or less stand upon its own bottom." [10] Furthermore, each contested salary must be justified. It is not enough for the taxpayer to show that the aggregate of officers' salaries is reasonable.[11] Excessive compensation to one officer cannot be defended by pointing to inadequate or modest compensation to other officers. Indeed, if the highly paid executive is the sole or dominant stockholder, the discrepancy in his favor suggests that it may be ascribable to his stock ownership and therefore is to be treated as a dividend.

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[7] Reg. 118, § 39.23(a)-6.

[8] See *Acer Realty Co.* v. *Commissioner* (8 Cir. 1942), 132 F. 2d 512. On the distinction between ordinary expenses and capital investments, see Abe L. Shugerman, "Basic Criteria for Distinguishing Revenue Charges from Capital Expenditures in Income Tax Computations," *Michigan Law Review*, December 1950, Vol. 49, page 213.

[9] Prentice-Hall, Federal Tax Service, 1954, par. 11,703-C through par. 11,703-J (cases collected under eight categories); Commerce Clearing House, Standard Federal Tax Reporter, 1954, par. 161,269 (cases arranged by type of industry or business); Research Institute of America, Federal Tax Coordinator, pages 11,841 to 11,852 (chart of numerous cases analyzed in tabular form).

[10] *Miller Mfg. Co.* v. *Commissioner* (4 Cir. 1945), 149 F. 2d 421.

[11] *Lydia E. Pinkham Medicine Co.* v. *Commissioner* (1 Cir. 1942), 128 F. 2d 986, cert. den. 317 U.S. 675 (1942); *L. Schepp Co.*, 25 B.T.A. 419 (1932); *Shield Co.*, 2 T.C. 763 (1943) For a criticism, but not reversal, of the Commissioner's disregard of this rule, see *Miller Mfg. Co.* v. *Commissioner*, footnote 10, above.

The problem of valuation, be it for property taxes, condemnation awards, payments to dissenting shareholders under corporation laws, or whatnot, arises in many phases of the law in our society. The primary and classic approach is the test of the market place. This test is to a considerable extent adaptable even to such an intangible matter as the value of personal services. It is fair to assume that when a freely bargaining corporate employer, through its independent board of directors, arrives at a mutually acceptable salary for an important executive, the very fact of the agreement carries its own badge of good faith and probability of reasonableness. Conversely, when the corporation is dominated by the employees by virtue of their stock ownership, the only true bargaining, if any there be, is between the stockholder-employees themselves as to their relative entitlements. The corporate entity is a helpless bystander. It takes two to make a bargain as well as a fight. The stockholder-employees in fact, though not in legal theory, are dealing with themselves and the safeguard inherent in the arm's length negotiation is absent.

However, even though so far as the corporation is concerned, salaries are fixed unilaterally by the recipients, the presence of articulate minority stockholders not employed by the corporation may be an effective brake on otherwise excessive salaries. The conflicting desires of the employed stockholders for high salaries and of the unemployed stockholders for high dividends may make up for the lack of bargaining power on the part of the corporation itself. This is particularly true where the charter, the by-laws, or the corporation law under which the corporation operates, requires cumulative voting for directors.

In the absence of adverse bargaining interests, the decisions time and again recognize that the situation requires careful scrutiny because of the likelihood that an ostensible salary is in fact and at least in part a dividend on the employee's stock. As the applicable Regulation pointedly observes, the payment of dividends in the guise of salaries "is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries"; and if, in addition, the salaries bear a close relationship to the stock holdings of officers or employees, their vulnerability as fully allowable deductions obviously becomes greater.[12]

The application of these observations, of course, becomes more pronounced in the case of the compensation paid to a sole stockholder, especially where the corporation has succeeded a sole proprietorship. In the latter situation, the sole stockholder through habit of mind is apt to continue to consider all earnings as his, to do with as he pleases.[13]

However, in spite of everything that has been said, the ultimate test of reasonableness may be found to have been complied with irrespective of the presence or even predominance of stockholding employees.[14] This is attested to by the substantial number of instances in which the taxpayer has prevailed by sustaining its deduction for compensation paid to such an employee. Chances of victory must be weighed by the application of established criteria to the circumstances of the particular taxpayer. Many of the factors of reasonableness persuasive in one situation, may be absent or inapplicable in another. With this in mind, the factors to be considered include: compensation paid for comparable services in comparable businesses;[15] comparison of salary and services of stockholder-employee with salaries and services of employees in the same corporation;[16] the time given by the employee to the business;[17] the quality and effectiveness of the employee's efforts; the responsibilities and difficulties of his position; the special skills or qualifications required by the work and possessed by the employee;[18] the presence or absence of a dividend paying record;[19] the approval by other unrelated stockholders not on the payroll;[20] comparison of the same officer's compensation in prior years and justification for sudden large increase;[21] prevailing economic conditions;[22] relation of compensation to gross income, net income, earned surplus, and dividends, especially over a period of years;[23] and the time of fixing compensation,[24] that is to say, cutting an existing melon is far different from fixing compensation for services to be rendered in the future.

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[12] Reg. 118, § 39.23(a)-6(b)(1).

[13] See for example *F. E. McGillick Co.*, par. 53,402 Prentice-Hall Memorandum T.C. (1953). Even if the sole stockholder (or close family group) attempts to recognize the separate identity of the corporation, here as in other phases of taxation it is apt to be treated by the law as a *sui generis* creature. See Jacob Rabkin, "The Close Corporation—Through the Looking Glass," *Proceedings of New York University Eighth Annual Institute on Federal Taxation*, page 664. New York: Matthew Bender and Company, 1950.

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[14] "The fact that these three men (petitioner's officers) were the only stockholders of petitioner is not important unless the salaries were unreasonable." *Eitel-McCullough, Inc.*, 9 T.C. 1132 (1947); appeal dismissed for failure to comply with appellate procedure (9 Cir. 1949), 175 F. 2d 438, cert. den. 338 U.S. 872 (1949).

[15] Though this test is emphasized in Reg. 118, § 39.23(a)-6, the absence of such a comparison is not fatal, especially if such absence is satisfactorily explained. In sustaining the taxpayer and reversing the Tax Court, the appellate court pointed to the taxpayer's uncontradicted evidence as to lack of fairly comparable businesses. *Mayson Mfg. Co.* v. *Commissioner* (6 Cir. 1949), 178 F. 2d 115. In *Faucette Company, Inc.*, 17 T.C. 187 (1951), the Court commented on the rather unusual failure to offer evidence of salaries for similar services in comparable businesses, which the Court characterized as "one of the most satisfactory tests." The taxpayer was sustained in full as to one year but the Commissioner was sustained in disallowing an increase in compensation for the following year. The Commissioner's comparison with salaries in a specific competitive business of the same size backfired when the taxpayer showed that its stockholder-employee did the work it took four or five of its competitor's employees to perform, in *Howard Sole, Inc.*, par. 53,076 Prentice-Hall Memorandum T.C. (1953). Recent decisions, in each of which a favorable comparison of the disputed salaries with those paid by concerns of comparable size in the same industry was a factor in the taxpayer's victory, are found in *R. J. Armstrong & Co., Inc.*, par. 53,038 Prentice-Hall Memorandum T.C. (1953); *C. and C. Beverage, Inc.*, par. 54,201 Prentice-Hall Memorandum T.C. (1954); and *Loesch & Green Construction Co.* v. *Commissioner* (6 Cir. 1954), 211 F. 2d 210.

[16] *Lydia E. Pinkham Medicine Co.* v. *Commissioner*, footnote 11, above (where the stockholders, whose salaries were disallowed in part, received more compensation than officers who rendered much greater services). The comparison is particularly damaging where the salary exceeds that of a non-stockholding employee who performs similar duties. Discriminatory payments to employees who are close relatives of principal stockholders are equally vulnerable. *Sohmer & Co., Inc.* v. *U.S.* (D.C., S.D. N.Y. 1949), 86 F. Supp. 670.

[17] *R. J. Armstrong & Co., Inc.*, footnote 15, above (60 hours a week, taxpayer prevailed); *Snyder* v. *Westover* (D.C., S.D. Calif. 1952), 107 F. Supp. 363 (worked seven days a week, taxpayer prevailed); *Heil Beauty Supplies, Inc.* v. *Commissioner* (8 Cir. 1952), 199 F. 2d 193 (no regular hours spent, 70 per cent stockholder-officer engaged in separate business, ostensible compensation disallowed in full).

[18] *Automotive Bin Service Co.*, par. 53,215 Prentice-Hall Memorandum T.C. (1953); *Howard Sole, Inc.*, footnote 15, above; *National Creations, Inc.*, par. 53,062 Prentice-Hall Memorandum T.C. (1953); *Streckfus Steamers, Inc.*, 19 T.C. 1 (1952); *Roth, Inc.* v. *Jarecki* (D.C., N.D. Ill. 1953), par. 72,434 Prentice-Hall, Federal Tax Service, 1953.

[19] *Ticket Office Equipment Co., Inc.*, 20 T.C. 272 (1953), affirmed (2 Cir. 1954) 213 F. 2d 318; *Howard Sole, Inc.*, footnote 15, above; *Heil Beauty Supplies, Inc.*, footnote 17, above; *University Chevrolet Co.*, 16 T.C. 1452 (1951), affirmed (5 Cir. 1952) 199 F. 2d 629; and cases cited in footnote 18, above.

[20] In *Howard Sole, Inc.*, footnote 15, above, such approval was convincing evidence of the arm's length nature of the compensation agreement there unsuccessfully attacked.

In concluding this section, the decision by the Court of Appeals for the Fifth Circuit in *R. P. Farnsworth & Co., Inc.* v. *Commissioner* merits special mention.[25] The case illustrates not only the application of many of the criteria mentioned above, but also the paramount importance of marshalling and presenting the evidence necessary to invoke such criteria. The taxpayer was sustained with respect to compensation paid to its seven stockholder-officers in the years 1942, 1943, 1944 and 1945. The Commissioner had previously failed in his attempt to disallow similar compensation for the year 1941.[26] The seven executives were men of high capacity, responsible for the growth and success of a general contracting and construction business. They devoted their entire time to the corporation. They secured its business, assumed the responsibility for the performance of its contracts and managed their execution to completion. Salaries were determined at the beginning of each year. The decisions as to dividends were made at the year's end. Dividends were paid in all but two of thirteen years. The taxpayer produced evidence to show, among other things, the scarcity of capable construction executives, the salaries paid by the taxpayer and by comparable firms, the general economic conditions affecting salaries, and the ratio of the salaries paid to the business done. The Commissioner produced no evidence in rebuttal. The Commissioner, however, pointed to a decline in taxpayer's business in the years 1944 and 1945 as justification for his disallowance with respect to those years. The Court rejected this contention because, though such years marked the decline from the peak of wartime construction work, taxpayer's officers had boldly embarked on a "dynamic program of expansion" and had worked harder for smaller profits on a large number of contracts.

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[21] *Faucette Company, Inc.*, footnote 15, above. In *National Creations, Inc.*, footnote 18, above, the corporation had paid no salaries in 1944 and 1945 although it had net profits; this was considered by the Court in finding that 1946 and 1947 salaries were reasonable.

[22] Where increased profits are ascribed to government war contracts requiring little or no increased effort, or to scarcity conditions as where an automobile dealer could sell all the cars he could obtain, these circumstances will be taken into account in evaluating the services rendered. *University Chevrolet Co.*, footnote 19, above. On the other hand where a civilian industry enters a military manufacturing field new to it, greatly increased efforts may be required of the officers and justify at least some increase in compensation. See *Edward G. Leuthesser*, 18 T.C. 1112 (1952), appeal dismissed (7 Cir.), Aug. 17, 1953, Prentice-Hall, Federal Tax Service, 1954, par. 71,022.

[23] Data such as this is generally set out in the Tax Court's findings of fact. As examples, see *R. J. Armstrong & Co., Inc.*, footnote 15, above; *Automotive Bin Service Co.*, footnote 18, above; *University Chevrolet Co.*, footnote 19, above.

[24] If a closed corporation fixes salaries or authorizes bonuses at a time when a normal corporation would be considering dividends, i.e., at the end of the year when the profits are known, attack is invited and defense is difficult. For a glaring example and complete disallowance of the deduction of lump sum payment to the controlling stockholder, see *Heil Beauty Supplies, Inc.*, footnote 17, above.

[25] (5 Cir. 1953) 203 F. 2d 490.

[26] Par. 47,061 Prentice-Hall Memorandum T.C. (1947), discussed in Eolis, *op. cit.*, footnote 4, above. In the more recent case, the Tax Court had upheld the taxpayer as to 1942 and 1943 but had upheld the Commissioner as to 1944 and 1945. It stressed the fact that the taxpayer's gross receipts and total operating profits decreased materially in those years in comparison to prior years. *R. P. Farnsworth & Co., Inc.*, par. 51,354 Prentice-Hall Memorandum T.C. (1951).

4. Deductibility of Contingent Compensation

Though the tests of reasonableness discussed in the preceding section are applicable to all compensation regardless of the form or method of payment,[27] compensation contingent upon sales or profits warrants separate discussion. In many businesses such a method of compensation is highly desirable from the incentive standpoint. In others, limited resources, relatively small working capital, and uncertainties of earnings, may make modest salaries plus contingent compensation the only satisfactory and sound method of operation.

Due to its very nature, contingent compensation "invites scrutiny as a possible distribution of earnings." [28] Implicit in such an arrangement is the fact that while it produces small compensation for the employee in a lean year, it may result in compensation in a good year in an amount greater than would be deemed reasonable for that year considered alone. This is recognized by the courts[29] and, more cautiously, by the Regulation last cited.

To illustrate the tests applicable to determine the reasonableness of contingent compensation, several of the comparatively recent decisions involving that question will be briefly noted.

The *University Chevrolet Company, Inc.*[30] was denied about half of its deduction for compensation paid on a contingent basis to its sole stockholder and principal executive. The contingent compensation plan had been originally negotiated at arm's length and put into effect some years prior to the acquisition of the corporation stock by the executive. This fact was given little weight although normally a compensation agreement is to be tested under the facts existing at the time it was made and not at the time the agreement is questioned.[31] The Tax Court stated that for "a sole owner to pay himself a bonus as an inducement to do his best in managing his own business is nonsense." Other factors considered were: the relationship of the officer's compensation to net income, to capital and to compensation of others; the corporation's dividend record; evidence as to salaries paid by other firms; and compensation paid the officer in prior years.

Streckfus Steamers, Inc.[32] successfully defended as reasonable the compensation paid four stockholder-officers pursuant to a contingent compensation plan which had been adopted at a time when they or their relatives owned approximately half of the stock. The plan had been consistently followed for twenty years. The Tax Court noted that while "the compensation paid in good years was liberal, in lean years it was less than adequate." Reasonable dividends had been paid. Finally, the personal efforts of these four officers were largely responsible for the company's success.

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[27] A bonus for services actually rendered is unobjectionable if, when added to the fixed salary, the resulting total is reasonable. Reg. 118, § 39.23(a)-8.

[28] Reg. 118, § 39.23(a)-6.

[29] See especially *Mayson Mfg. Co.* v. *Commissioner* (6 Cir. 1949), 178 F. 2d 115, *Home Packing Co.*, par. 53,346 Prentice-Hall Memorandum T.C. (1953), both in favor of the taxpayers, and *Commercial Iron Works* v. *Commissioner* (5 Cir. 1948), 166 F. 2d 221, where the Court most reluctantly felt constrained to affirm the Commissioner's disallowance.

[30] Footnote 19, above.

[31] Reg. 118, § 39.23(a)-6, (b)(3).

[32] Footnote 18, above.

Heil Beauty Supplies, Inc.[33] paid an annual compensation to its principal stockholder in an amount equal to five per cent of its total sales. However, this amount was authorized by corporate action as a lump sum payment at the end of each year. The taxpayer failed to show just what services the stockholder performed and further failed to show any relationship between the services, such as they were, and the sales. The entire amount was disallowed as a deduction.

In *Baltimore Dairy Lunch, Inc.* v. *United States,*[34] an employment contract with the principal stockholder and general manager had been largely disregarded in practice and in the year in question the general manager's salary had been fixed by himself without consulting the minority stockholder. The salary "was quite evidently determined solely on the basis of the amount of money available in the business for that purpose." The Commissioner's disallowance of over half the salary paid was upheld by the District Court.

Compensation paid on an entirely contingent basis under a written agreement which, with modifications, had been in effect for a number of years, was allowed in full as to two of the three sole stockholders and directors, but disallowed in part as to the third in *American Allsafe Co., Inc.*[35] No dividends had been paid on the stock but the compensation was markedly disproportionate to the stockholdings. The two officers whose compensation was allowed in full, during the depression when others then participating in the business wished to liquidate it, had agreed that if the business were continued, their entire compensation would be contingent upon profits. They were key men whose persistence and ability were largely responsible for building the business into a profitable enterprise. The compensation of the president was deemed excessive largely because the amount of time he gave to the business was indeterminate and he was employed as an executive of an entirely unrelated enterprise to which he devoted most of his efforts.

In *Roth, Inc.* v. *Jarecki,*[36] deduction was allowed for compensation paid to the managing stockholder based upon a moderate fixed salary plus a percentage of earnings. Persuasive elements were: the approval by an independent majority of directors; the manager's special qualifications, long working hours, heavy responsibilities, and successful innovations; the corporation's dividend record; and expert testimony by outside witnesses of wide experience in the particular business field.

Last but not least, is the case of the *Automotive Bin Service Company,*[37] where the taxpayer successfully defended as a deduction completely contingent compensation paid to its sole stockholder and chief officer. The compensation was computed as a percentage of sales under an agreement made several years prior to the tax year in issue. Though the taxpayer had paid no dividends, it prevailed because of: the initiative and ingenuity of the officer in conceiving and developing the basic idea of the corporation's product; a favorable comparison of the officer's contested earnings with his former commissions in a similar business; and the fact that he was responsible for all the taxpayer's sales in two of the four contested years and for a very large percentage of its sales in the other two.

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[33] Footnote 17, above.

[34] (D.C., Minn. 1954) 121 F. Supp. 356.

[35] Par. 54,033 Prentice-Hall Memorandum T.C. (1954).

[36] Footnote 18, above.

[37] Footnote 18, above.

5. Tax Results of Excessive Compensation

The immediate effect of the determination that compensation is unreasonable is of course the loss of the deduction by the corporation of the portion deemed excessive and the consequent payment of a corporate tax thereon. So far as the stockholder-employee is concerned, such excess may be treated as a dividend. In any event, unless there is clear justification for some other treatment, excessive compensation payments will be included in the recipient's gross income.[38] Such, generally, is the result.

In a factually extraordinary case, excessive salary payments by a charitable corporation resulted in the Commissioner contending successfully that its earnings thereby inured to the benefit of the officer who received the compensation. The corporation's tax exempt status was thus forfeited.[39]

Finally, if, after compensation has been determined to be excessive, the corporation is unable to pay the resulting deficiency, the stockholder-employees who received it may be held liable for the unpaid corporate tax. The Supreme Court has held that inasmuch as such compensation had been received in the year of payment under a "claim of right," the employee recipient is taxable for that year without offset for his subsequently determined transferee liability.[40] The Court rejected the theory that such compensation had been received by the officers as constructive trustees. It also stressed the importance of annual accounting under the income tax law. The Government conceded that the taxpayers were entitled to a deduction for a loss in the year of repayment of the amount previously included in their income.[41]

6. Delaying Payment of Accrued Compensation to Stockholder-Employee

Section 267(a)(2) of the 1954 Code[42] is designed to disallow deductions of expenses and interest, otherwise deductible under section 162,[43] payable by taxpayers on the accrual basis to certain related taxpayers who do not account for such payments in their own gross income. Though by no means limited to such situations, the section has particular application to the deduction by a corporation of compensation payable to a controlling stockholder-employee.

Prior to the enactment of such a provision (first incorporated in the Revenue Act of 1937), a closely held corporation reporting on the accrual basis and its controlling stockholder-officer reporting on a cash basis could avoid or defer taxes by the simple device of having the corporation accrue such officers' salaries, thereby obtaining the tax benefit of the deduction, while the officers either failed to withdraw the salaries, thereby avoiding a tax thereon, or postponed the withdrawal until some more favorable tax year.

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[38] Reg. 118, § 39.23(a)-7.

[39] *Mabee Petroleum Corp.* v. *U.S.* (5 Cir. 1953), 203 F. 2d 872.

[40] *Healy* v. *Commissioner,* 345 U.S. 278 (1953), affirming *Commissioner* v. *Hartfield* (2 Cir. 1952), 194 F. 2d 662 and reversing *Commissioner* v. *Smith* (6 Cir. 1952), 194 F. 2d 536.

[41] On the general subject of the return of compensation to a corporation by stockholder-employees, see Edward H. Schlandt, "Returnable Compensation Arrangements in Closely Held Corporation," *Proceedings of New York University Eighth Annual Institute on Federal Taxation,* page 724, New York: Matthew Bender and Company, 1950.

[42] 1939 IRC § 24(c).

[43] 1939 IRC § 23.

The section prohibits the deduction of compensation when three conditions exist, which, following the statutory format, may be paraphrased for present purposes, as follows:

(A) If within the period consisting of the corporation's taxable year and two and one-half months after its close—
  (i) the compensation is not paid, and
  (ii) the amount thereof is not includible in the gross income of the payee; *and*
(B) the compensation, under the employee's method of accounting, is not, unless paid, includible in his gross income for the taxable year in which or with which the taxable year of the corporation ends; *and*
(C) more than fifty per cent in value of the outstanding stock of the corporation is owned, *directly or indirectly, by or for* the employee.

Condition (C) is derived from section 267(b)[44] which is incorporated by reference into section 267(a)(2) for the purpose of defining the operative stockholder relationship.

Stated more simply, the effect of the statute is the disallowance of a deduction in the following situation: the employee is on a cash basis and through the stock ownership of himself or of others is in a dominant position; the corporate employer accrues his compensation but it is neither paid until more than two and one-half months after the taxable year nor is it includible in the employee's taxable income by constructive receipt within such two and one-half months' period.

The computation of the fifty per cent stock ownership must be carefully considered in many cases to determine just how much stock, held by others, is to be attributed to the particular employee. For example, a person owning outright in his own name little or even no stock could be a fifty-one per cent stockholder when shares owned by relatives, by partners, and by corporations or trusts in which he has beneficial interests are deemed to be his shares under the rules of constructive ownership set forth in section 267(c).

Constructive ownership is not the only factor which must be considered constructively in the application of the statute. Constructive payment and constructive receipt have played their roles in the somewhat tortuous history of this section. Prior to the Technical Changes Act of 1953,[45] clause (ii) of condition (A) set out above, was missing. Payment within the prescribed period was required to escape the impact of condition (A).

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[44] As indicated earlier in the text, references here are to the 1954 Internal Revenue Code, section 267 of which is derived from sections 24(b) and 24(c) of the 1939 Code. Though important changes were made by the new law respecting other transactions between related taxpayers, no material changes were made concerning the present narrow subject of stockholding employees.

[45] Sec. 202, P.L. 287, August 15, 1953, 67 Stat. ch. 512, amending 1939 IRC § 24(c)(1). The amendment was made retroactive in application to taxable years beginning after December 31, 1950, and at the employer's election if exercised on or before August 15, 1954, to taxable years beginning after December 31, 1945. T.D. 6089, approved August 10, 1954, amended Reg. 111, § 29.24-7 and Reg. 118, § 39.24(c)-1 to reflect this amendment.

The question naturally arose as to what constituted payment. The corporation's promissory note has been held to satisfy this requirement when, because of its negotiability, terms, and the maker's solvency, it was fairly tantamount to payment and was accepted as such.[46] This has been the result even though the note was neither paid nor payable until after the two and one-half months' period.[47]

But what about the other side of the coin, constructive receipt of the compensation? Suffice it to say, in this brief review, that apparently constructive receipt[48] by the employee within the employer's taxable year would save the latter's deduction,[49] but constructive receipt within the two and one-half months' period after the close of such year would not. For example, in *L. R. McKee*[50] the deduction was disallowed where the cash-basis employee was entitled to compensation based on the year's profits and where the amount, though accrued as of the end of the taxable year, was computed and credited within a month thereafter. The Tax Court held that condition (A) was not avoided because there was no actual payment within the two and one-half months' period and condition (B) was not avoided because the corporation and the employee both reported on the calendar year basis.

That is to say, under former section 24(c) of the 1939 Code, the fact that the accrued compensation became taxable to the stockholder within the two and one-half months' period was not enough. The Technical Changes Act of 1953 removed this irrationality by adding clause (ii) to condition (A).[51] As a result of that Act and its retroactive application, the Tax Court's denial of the salary deduction in *L. R. McKee*, cited above, was reversed by stipulation in the appellate court.[52]

The amendment made by the Act happily has been preserved in section 267 of the 1954 Code, which, unhappily, also preserves the cumbersome form of section 24(c). In short, despite the fact that the corporation and the stockholder have the same taxable year, the present law permits the corporation to deduct accrued compensation when it is credited and unqualifiedly made available to the stockholder within the two and one-half months' period, even though it is not actually paid during that period.[53]

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[46] *Akron Welding & Spring Co.*, 10 T.C. 715 (1948), five judges dissenting; *Anthony P. Miller, Inc.* v. *Commissioner* (3 Cir. 1947), 164 F. 2d 268, reversing 7 T.C. 729 (1946), cert. den. 333 U.S. 861 (1948); *Musselman Hub-Brake Co.* v. *Commissioner* (6 Cir. 1943), 139 F. 2d 65; *Mundet Cork Corp.*, par. 48,119 Prentice-Hall Memorandum T.C. (1948), affirmed (2 Cir. 1949) 173 F. 2d 757. The Court of Appeals for the Fifth Circuit, in affirming a Tax Court holding (under the law prior to the Technical Changes Act of 1953, footnote 45, above) that the facts under which a corporation credited salary to its president's account did not constitute constructive payment, stated broadly that the corporation could not "escape the penalty of the statute by claiming constructive payment when in fact no payment had been actually made." *Ashe Electric Co.* v. *Commissioner* (5 Cir. 1946), 153 F. 2d 295; see also *P. G. Lake, Inc.* v. *Commissioner* (5 Cir. 1945), 148 F. 2d 898, cert. den. 326 U.S. 732 (1945).

[47] *Mid-State Products Co.*, 21 T.C. 696 (1954).

[48] For the general rule of constructive receipt see Reg. 118, § 39.42-2.

[49] *National Creations, Inc.*, footnote 18, above, in which it was so held on the stated ground that condition (B) in the text was not present.

[50] 18 T.C. 512 (1952). There the related taxpayers were father and son, rather than corporation and controlling stockholder, but this, of course, does not affect the point under consideration.

[51] Footnote 45, above.

[52] *L. R. McKee* v. *Commissioner* (8 Cir.), Docket No. 14718, Oct. 28, 1953.

Finally, it should be emphasized, first, that section 267 will not bar the deduction unless all three of the statutory conditions of disallowance coexist, and, second, that if the deduction is disallowed under section 267, it is lost forever and cannot be recouped by subsequent actual payment.[54]

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[53] It would seem that condition (B) in the text is now useful to the taxpayer only in cases when the corporation and the stockholder have overlapping taxable years.

[54] Reg. 118, § 39.24(c)-1.

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How to Use Pension and Profit-Sharing Plans

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A new tax era for pension and profit-sharing plans began with the Revenue Act of 1942.[1] Enough of this era has elapsed to permit the development of guides for the proper establishment and administration, taxwise, of such plans.[2] This chapter is principally concerned with giving a brief record of these guides, including changes —almost all liberalizing in nature—made by the Internal Revenue Code of 1954.[3]

1. Points to Consider

An employer desirous of setting up a pension or profit-sharing plan should be particularly interested in the answers to these questions:

	Section
What are the essential differences between a pension and a profit-sharing plan?	2
What are some of the types of plans or combinations of plans that can be used?	2
What are some of the factors which will help decide what kind of plan should be used?	2
What tax advantages are offered if a plan "qualifies"?	3
What are the basic requirements for qualification of a plan?	4, 5, 6, 7

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[1] Sec. 162, amending 1939 IRC Sections 22(b)(2), 23(p) and 165. For comparison of the 1942 law with prior law and background of the 1942 law, see Walter D. Freyburger, "Pension Plans—the Philosophy of Section 165(a)," *Taxes*, February 1944, Vol. 22, page 60; Leon L. Rice, Jr., "Employee Trusts under the Revenue Act of 1942," *Taxes*, December 1942, Vol. 20, page 721; and Isidore Goodman, "Federal Income Tax Aspects of Pension, Profit-Sharing and Stock Bonus Plans," *The American University Tax Institute Lectures*, Vol. 5, page 207, New York: Matthew Bender and Co., 1953.

[2] Detailed regulations and numerous rulings have been published by the Treasury Department. The Annual Report of the Commissioner of Internal Revenue for the fiscal year ended June 30, 1954, showed that unpublished rulings on the initial qualification of 26,464 plans had been issued by the end of that fiscal year. 1,337 applications for rulings were then on hand.

[3] H.R. 8300, 83d Cong. 2d Sess. Owing to space limitations, this record cannot be complete. For complete coverage, the reader should consult the Prentice-Hall Pension and Profit-Sharing Service (loose leaf). An excellent summary of the rules relating to the qualification of plans under IRC Sec. 165(a) is contained in Rev. Rul. 33, 1953 I.R.B. No. 6. *Caveat:* When this chapter was being finally prepared for publication, the applicable regulations under the 1954 Code had not been promulgated.

Section

What are the rules for deducting contributions under pension plans? 10, 11
What are the rules for deducting contributions to a profit-sharing trust? 10, 12
What are the rules for deducting contributions under combinations of plans? 13
How are employees taxed? 15
Under what circumstances can a plan be curtailed or terminated without unfavorable tax results? 16

2. Kinds of Plans and Funding Methods

The law[4] refers to four kinds of plans of deferred compensation for employees:[5] pension, profit-sharing, annuity, and stock bonus plans. An annuity plan is a form of pension plan under which retirement benefits are provided through annuity or insurance contracts without the use of a trust.[6] A stock bonus plan, which is rare, resembles a profit-sharing plan and is generally subject to the same requirements as a profit-sharing plan.[7] Accordingly, this chapter will be confined to pension and profit-sharing plans. Also, it will be limited to funded plans—those under which funds are segregated and accumulated for future distribution to employees.

By examining these parallel columns, some of the fundamental differences between a pension plan and a profit-sharing plan can be seen:[8]

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[4] 1954 IRC Sections 401, 404; 1939 IRC Sections 165(a), 23(p). Section 165(a) (now Section 401) applies only to plans established by employers, and not to plans established by employees. Times Publishing Company, 13 T.C. 46 (1949), affirmed per curiam (3 Cir. 1950) 184 F. 2d 376. But the Treasury holds that a plan may qualify under which only employees contribute if the employer obligates itself to take care of pensions if the trust funds are exhausted. Rev. Rul. 54-152, 1954 I.R.B. No. 18. Under Section 401, a trust can be exempt only if it is created or organized in the United States. The Treasury has had to stretch the law a bit to encompass union-negotiated plans. These plans, including plans under contracts with individual employers, industry-wide plans, and area-wide plans, are beyond the scope of this chapter, but a discussion thereof may be found in the article by Goodman, *op. cit.*, footnote 1, above, beginning at page 239. The 1954 law, Section 404(c), contains provisions which will allow the coal operators (and possibly others) to deduct as business expenses under Section 162 contributions to the U.M.W. welfare fund.

[5] General partners, not being employees, cannot be covered for tax purposes. I.T. 3350, 1940-1 C.B. 64. Likewise, sole proprietors. Former employees may be covered. Reg. 118, Sec. 39.165-1(a). Full time life insurance salesmen are considered employees. 1939 IRC Sec. 3797(a)(20), 1954 IRC Sec. 7701(a)(20). An election of a proprietorship or partnership to be taxed as a corporation does not make the proprietor or partners eligible for coverage. 1954 IRC Sec. 1361(d). For a case in which a group of physicians obtained pension coverage under the 1939 Code, by organizing an association taxable as a corporation, see *U.S.* v. *Kintner* (9 Cir. 1954) 216 F. 2d 418.

[6] Reg. 118, Sec. 39.23(p)-4.

[7] Reg. 118, Sec. 39.165-1(a). However, under a stock bonus plan, contributions are not necessarily based on profits, and benefits are distributable in stock of the employer. For case involving alleged stock bonus plan, see Wm. M. Bailey Co., 15 T.C. 468 (1950), (affirmed 3 Cir. 1951) 188 F. 2d 360.

[8] *Ibid.* These differences are based almost entirely on definitions in the Regulations cited. The courts are not in agreement with the Regulations on the question of the necessity for a definite formula in a profit-sharing plan. See Section 7 of this chapter. The Treasury holds that a profit-sharing plan cannot provide for distributions within less than 2 years. Rev. Rul. 54-231, 1954 I.R.B. No. 25.

Pension Plan	*Profit-Sharing Plan*
Designed to provide deferred retirement benefits, usually for life, after retirement.	Designed to provide deferred participation in employer's profits, either after retirement or at some earlier predetermined time.
Benefits are definitely determinable in advance of funding.	Benefits are indeterminate in advance of funding.
Benefits are generally measured by and based upon such factors as years of service and compensation of employees.	Benefits are dependent upon the amount available.
Cost and/or benefits are determined actuarially, and bear no necessary relation to employer's profits.	Cost is based on definite formula for fixing employer's profits to be shared, and benefits are based on definite formula for distributing funds accumulated under plan.
Forfeitures from terminations of service must be used to reduce employer's contributions.	Forfeitures from terminations of service may be used to provide increased benefits for remaining participants.[9]
Reversion to employer of excess amounts due to erroneous actuarial calculations permitted on termination of plan.	No reversion to employer permitted on termination of plan.[10]

A pension or profit-sharing plan may be variously characterized by one or more of the following generic terms:

Trusteed:	Assets under the plan are held by one or more trustees, individual or corporate.
Insured:	Risks and obligations under the plan are assumed by a life insurance company, in return for premium payments.
Contributory:	Employee participants contribute to the cost of the benefits under the plan.

Conversely, a plan may be described as "non-trusteed," "uninsured," or "non-contributory."

There are four conventional methods of funding pension plans. Here are designations and short descriptions of these methods:[11]

Individual policy plan (*insured*): A trusteed plan under which an individual, level-premium, retirement income policy providing life insurance protection before maturity is purchased for each insurable participant and under which a similar retirement annuity policy without life insurance protection is purchased for each uninsurable participant.

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[9] Reg. 118, Sec. 39.165-4.

[10] Rev. Rul. 33, footnote 3 above.

[11] For more adequate descriptions, see Hugh O'Neill, *Modern Pension Plans*, page 103 and following. New York: Prentice-Hall, Inc., 1947; Birchard E. Wyatt, and others, *Employee Retirement Plans*, pages 60-78. Washington, D.C.: Graphic Arts Press, Inc., 1945; Goodman, *op. cit.*, footnote 1, above, beginning at page 219.

Group annuity plan (*insured*): A non-trusteed plan under which annuities without life insurance protection are purchased for a group of participants on a unit, single premium, deferred annuity basis.

Group permanent plan (*insured*): An ordinarily non-trusteed plan combining some of the features of an individual policy and a group annuity plan.

Wholly invested[12] *plan* (*uninsured*): A trusteed plan under which retirement income without life insurance protection is provided by contributions of amounts certified by an independent actuary as being required to provide the retirement income, which contributions are invested by the trustee in securities or other media.

Various combinations of plans or funding methods are available to meet particular objectives. Some examples are:

1. A profit-sharing plan involving the purchase of an individual life insurance, retirement income, or annuity policy for each participant with a portion of the profits credited to his account.[13]
2. A profit-sharing plan involving the purchase of an immediate annuity policy for each participant upon retirement with the funds credited to his account at that time.
3. A pension plan with moderate benefits supplemented by profit-sharing plan covering same employees.[14]
4. An individual policy pension plan covering employees earning more than $3,000, $3,600, or $4,200 a year, and group annuity, wholly invested or group permanent plan covering employees earning less than such amount.
5. A pension plan involving actuarially determined contributions to a pension trust, a portion of the contributions being used to purchase ordinary life insurance policies for insurable participants and deferred annuity policies for uninsurables. The balance of the contributions is invested in securities by the trustee for the purpose of converting the policies at retirement (upon a basis guaranteed when the policies were purchased) to an annuity policy yielding the benefits called for by the plan.[15]
6. A pension plan involving actuarially determined contributions to an insurance company to be held in a deposit account to which interest is credited. When a participant retires, the insurance company withdraws from the deposit account the necessary amount to provide an immediate annuity of the amount to which the participant is entitled, at rate guaranteed by the contract.[16]

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[12] The writer prefers the use of this term rather than "self-administered" or "self-insured," either of which is a misnomer.

[13] See P.S. No. 11, 1944 Prentice-Hall par. 66,336. See also Section 7 of this chapter.

[14] But a profit-sharing plan cannot be a "feeder" to a pension plan. P.S. No. 37, 1944 Prentice-Hall par. 66,398. However, an employee who has a vested right under a profit-sharing plan may, if the plan so provides, authorize the transfer of all or part of his vested interest to make up for a deficiency in the employer's contribution under a pension plan. But in such case, he will be taxable on the transfer as though a distribution had been made to him. Rev. Rul. 33, *op. cit.*, footnote 3, above.

[15] This is sometimes called the Houston Plan. A pension plan cannot be funded solely with ordinary life insurance policies. Rev. Rul. 54-67, 1954 I.R.B. No. 8.

[16] This is called a Deposit Administration Plan.

7. A pension plan designed to hedge against changes in the cost of living, under which benefits are made up in part of a variable annuity funded by common stock investments and in part of a fixed dollar annuity funded by insurance or bond investments.[17]

In deciding what type (or combination of types) of plan or funding method will be used, much confusion can be avoided by considering at the outset such basic factors as the employer's objectives, the employer's ability and willingness to pay, the employees to be covered, and the benefits desired. A wise decision can best be made under the guidance of an independent consultant experienced in the field.[18]

It is recognized that it is impossible to generalize about what is the "best" plan or funding method for a particular employer. Nevertheless, as aids in arriving at such a decision, the following should be considered:

1. For tax purposes, deductions are somewhat more liberal with respect to profit-sharing plans than with respect to pension plans. See Sections 11 and 12 of this chapter.

2. A profit-sharing plan alone can hardly provide an adequate retirement income for participants who are anywhere near retirement age at the time the plan is established.[19] Combination with a pension plan may be indicated.

3. The so-called "fixed" liability under a pension plan may not be as fixed as appears at first glance. It is fixed to the greatest extent under an individual policy plan, but even this may be subject to alleviation.[20] It may be possible to maintain a pension plan for a considerable time with relatively small contributions.[21] Operating loss carry-overs and carry-backs can help. Conversely, there is a fixed liability under a profit-sharing plan to contribute what the contribution formula calls for, regardless of the employer's needs for retaining profits for expansion and other requirements.

4. A plan with small coverage—less than 50 employees, for example—is, as a

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[17] *J. K. Lasser Reports on Taxes,* October 15, 1952. The Treasury rules that such a plan does not mitigate against the requirement that benefits be definitely determinable. Rev. Rul. 185, 1953 I.R.B. No. 19.

[18] In general, on the subject of choice of plan or funding method, see Hugh O'Neill, *op. cit.,* footnote 11 above, page 233 and following; James A. Hamilton, "Employee Benefit Plans," Trusts and Estates, December 1946, Vol. 83, page 583.

[19] Meyer M. Goldstein, "What Is New in Organizing, Amending and Operating Your Pension and Profit-Sharing Trusts," *Proceedings of New York University Sixth Annual Institute on Federal Taxation,* pages 915-917, New York: Matthew Bender and Company, 1948. Norman McClave, Jr., "Profit-Sharing Plans Today," *Trusts and Estates,* June 1947, Vol. 84, page 607. See I.T.'s 3685 and 3686 in Section 6 of this chapter, footnote 39.

[20] Goldstein, *op. cit.,* footnote 19 above, suggests that deductions for contributions under individual policy plans be handled under clause (iii) of 1939 IRC Sec. 23(p)(1)(A) (1954 IRC Sec. 404(a)(1)(B)) instead of under clause (ii), thus permitting the contribution of extra amounts to a supplementary invested trust fund in good profit years to meet premium payments in poor profit or loss years. *Cf. South Penn Oil Co.,* 17 T.C. 27 (1951) *non-acq.* 1952 I.R.B. No. 13.

[21] The prior qualification of a plan will not be affected by a reduction or suspension of contributions if benefits are not affected and if the unfunded past service cost does not exceed such cost when the plan was established. P.S. No. 57, 1946 Prentice-Hall par. 76,237. Thus, it may be possible to contribute the "normal cost for the year" plus interest on the unfunded past service cost.

practical matter, restricted to an individual policy pension plan or a profit-sharing plan, or combination thereof. This stems from the minimum coverage requirements of insurance companies for group plans and, in the case of wholly invested pension plans, from actuarial considerations.[22]

5. If it is desired to provide life insurance protection before retirement under a pension plan, an individual policy or group permanent plan is indicated.
6. Costs under a pension plan may be kept down by making it a "pure" pension plan, providing only retirement income. The group annuity and wholly invested plans commonly lend themselves best to this type.
7. A wholly invested pension plan offers the highest degree of flexibility as to contributions and benefits of any method of funding pension plans.

3. Importance of Qualification

It is well to be certain that the plan "qualifies" under Section 401 of the law. If it qualifies, these tax advantages follow:

1. The employer may deduct, within limits, contributions under the plan as they are made.
2. The participants may defer the payment of income tax on benefits provided by the employer contributions until the benefits are received, actually or constructively.[23]
3. Any trust income earned under the plan is tax exempt in the hands of the trustee.

If the plan does not qualify, these are the unfavorable tax results:

1. The employer can obtain a deduction for contributions only if the interests of the participants in the contributions are non-forfeitable.[24] In such a case the employer's contributions are deductible, within limits, when made, and the participants must concurrently pay income tax on the contributions.[25]
2. If the interests of the participants are forfeitable when the contributions are made, the employer loses completely the right to deduct them.[26]
3. Any trust income earned under the plan is taxable in the hands of the trustee.

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[22] The minimum coverage requirement under group annuity or group permanent plans is usually 50 or 100 employees. Opinions differ widely about the minimum number that may properly be covered by a wholly invested plan. Some put it as high as 5,000 or 10,000, at least unless the employer is financially strong enough to take up any slack. Hugh O'Neill, *op. cit.*, footnote 11, above, at page 247. Suggestion has been made that a small group may be covered if conservative assumptions are made. Hamilton, *op. cit.*, footnote 18, above, at page 583. Actually, numerous such plans have been established with relatively small coverage, even as low as 25 or 50. Apparently, the Treasury has raised no question about the smallness of the coverage for tax purposes.

[23] Other advantages are that lump sum distributions may be taxed as long term capital gains and that unrealized appreciation in the value of employer securities is not taxed. See table in Section 15 of the text.

[24] 1939 IRC Sec. 23(p)(1)(D), 1954 IRC Sec. 404(a)(5).

[25] 1939 IRC Sections 22(b)(2)(B) and 165(c), 1954 IRC Sections 404(a)(5) and 402(b). The Technical Changes Act of 1949 added a new subsection (d) to Section 165 of the 1939 Code (1954 IRC Sec. 402(d)) that insulates participants from income tax in the case of certain nonqualified annuity plans put into effect before October 21, 1942. See *Bertram Allenberg,* 13 T.C. 942 (1949), *acq.* 1950-1 C.B. 1.

[26] Reg. 118, Sec. 39.23(p)-11.

4. Qualification—Non-discrimination

The chief requirement for the qualification of a plan is that it must benefit employees in general—it must not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees. (For convenience, these are often referred to as "key employees.") This non-discrimination requirement applies to *employee coverage* and to *contributions or benefits* under the plan. A plan which is non-discriminatory as to employee coverage will not qualify if it is discriminatory as to contributions or benefits. A plan must not only be non-discriminatory as to form, but, more important, in its actual operation.[27]

5. Qualification—Non-discrimination—Employee Coverage

A plan will qualify as to coverage if it meets a mathematical test.[28] In applying this test, these categories of employees may be disregarded:

1. employees who have been employed not more than a minimum period prescribed by the plan, not exceeding five years;
2. employees whose customary employment is for not more than twenty hours in any one week;
3. employees whose customary employment is for not more than five months in any calendar year.

Considering employees who are *not disregarded* as the "remaining employees," the plan must cover either (1) 70 per cent or more of the remaining employees, or (2) 80 per cent or more of those eligible, provided 70 per cent or more of the remaining employees are eligible to participate.

A plan will qualify as to coverage if it sets up a coverage classification that is found by the Commissioner not to be discriminatory in favor of key employees.[29] Thus, for example, coverage may be confined to employees in these categories: those who have been employed for a specified number of years, have attained a certain age, are compensated on a salary basis, are clerical employees, are employed in certain departments of the business, receive compensation in excess of the maximum amount considered as "wages" under the Federal Insurance Contributions Act, or fall within a combination of such classifications—provided, always, the effect of the coverage is not to discriminate in favor of key employees.[30]

In actual practice, it is probable that the mathematical test of qualification has been of small utility.[31] The Treasury Department has been so liberal in approving special classifications as non-discriminatory that it has not been found necessary in most cases to resort to the mathematical test. Especially is this true with respect to plans covering employees earning more than $3,000 or $3,600 or $4,200 a year; plans "integrated with Social Security." In a published ruling, such a plan was approved which covered only ten per cent of the employees.[32] Particular plans have been held to qualify that included much less than ten per cent of the total employees, even though such plans were not integrated with Social Security.

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[27] Reg. 118, Sec. 39.165-1(a). See *H.S.D. Co.* v. *Kavanagh* (D.C. E.D. Michigan, 1949), 88 F. Supp. 64.

[28] 1939 IRC Sec. 165(a)(3)(A), 1954 IRC Sec. 401(a)(3)(A).

[29] 1939 IRC Sec. 165(a)(3)(B), 1954 IRC Sec. 401(a)(3)(B).

[30] Reg. 118, Sec. 39.165-3. An employer having more than one plan may designate a combination of plans as constituting one plan for the purpose of meeting coverage conditions. The coverage conditions need be met only on one day of each quarter of the taxable year of the plan.

[31] It is believed that the mathematical test may be used to qualify a plan where eligibility conditions are, in and of themselves, discriminatory in favor of key employees; as, for example, one providing a shorter eligibility period for officers than for other employees. But such a plan would not qualify if it should discriminate as to contributions or benefits.

Below are a few suggestions for consideration in determining and drafting the coverage provisions of a plan:

1. The coverage provisions should be definite and non-discretionary. Define the term "employee." Specify the effect of leaves of absence, service in the armed forces in war and in peacetime,[33] and re-employment after a termination of employment.
2. Administration of all plans, especially individual policy plans, is facilitated by having one eligibility date a year. Under profit-sharing plans, make the eligibility date the last day of the employer's taxable year.
3. If the plan is contributory, avoid burdensome contributions which will make it likely that only the highly paid employees will elect to participate. In general, the Treasury does not consider employee contributions of six per cent or less to be burdensome.[34]
4. Differences in eligibility requirements for present and future employees are permissible, if the present key employees can meet the requirements for new employees. Example: If all present employees are eligible regardless of age and only those new employees who are at least age 30 can participate, this is not objectionable if all key employees are age 30 or over.[35]
5. Provision may be made for denial of participation upon failure to enter the plan upon becoming eligible, if the denial is based on something more than the mere giving of consent to participate—for example, refusal to authorize salary deductions under a contributory plan, refusal to submit to a physical examination under an insured plan. However, adequate notice should be given to the employee of the consequences of his failure to comply.[36]

6. Qualification, Non-discrimination, Contributions or Benefits

Generally, in order to avoid the prohibited discrimination, contributions or benefits should bear a uniform relationship to the compensation of the participants, or to a uniformly applied combination of compensation and length of service with employer.

There follow below summaries of some outstanding rules established by the

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[32] I.T. 3614, 1943 C.B. 476. The Treasury has also ruled that a pension plan can qualify even though it covers only one employee (being the sole employee of the employer). Rev. Rul. 55-81, I.R.B. 1955 No. 7.

[33] A provision about service in the armed forces should be drawn in the light of the Act of Congress relating to re-employment rights after such service.

[34] Rev. Rul. 33, *op. cit.*, footnote 3, above.

[35] *Ibid.*

[36] *Ibid.*

Treasury to limit the possibility of effecting the prohibited discrimination as regards contributions or benefits:

Integration with Social Security[37]	A plan which results in relatively or proportionately greater benefits for employees earning above any specified amount of compensation may be found to be discriminatory, unless the differences in benefits are approximately offset by Social Security benefits. For this purpose, the Social Security benefit of an employee may be considered as 150 per cent of the primary benefit. Acceptable methods of avoiding the prohibited discrimination are set forth in Mimeograph 5539, applicable generally to plans that exclude employees earning not more than $3,000 a year, and in Mimeograph 6641, supplemented in I. R. Mim. 97, applicable generally to plans where the minimum compensation level is $3,600, the latter mimeograph having been issued in view of the Social Security Amendments of 1950 and the supplement in view of the Social Security amendments of 1952.
Increases of compensation[38]	A pension plan under which benefits are based upon compensation should provide that when a participant's base compensation is increased, his retirement benefit shall be increased. Provisions that no increases of benefits shall be made on account of increases of compensation after attainment of a specified age, or that no increases of benefits shall be effective unless an increase of compensation would provide increased benefits of $10 a month or more, are acceptable.
Profit-sharing allocation formulae, taking into account years of service[39]	Although a profit-sharing distribution formula may take into account the periods of service of participants, a formula that results, on the average, in giving highly paid employees larger amounts in proportion to pay than the lower paid participants, will be considered discriminatory in favor of the highly paid participants.
Early termination of pension plans[40]	In the event a pension plan is terminated, or the full current costs are not met, within the first ten years after it is established, the funds that can be used for the benefit of the 25 highest paid employees whose expected retirement benefits will exceed $1,500 a year are subject to certain limitations. The maximum employer contributions which can be used for any such employee are the greater of (a) $20,000, or (b) 20 per cent of the employee's annual compensation, or $10,000, whichever is less, multiplied by the number of years since the establishment of the plan. See P.S. Nos. 38 and 42 for examples of acceptable and non-acceptable provisions for the purpose of satisfying the requirements of Mim. 5717.

Here are some definitive ideas which should be taken into account on the subject of non-discrimination as to contributions or benefits:[41]

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[37] Mim. 5539, 1943 C.B. 499; Mim. 6641, 1951-1 C.B. 41, supplemented by I.R.Mim. 97, 1953 I.R.B. No. 3, p. 54. As this chapter went to press, the Treasury had not yet issued the rules applicable to the Social Security Amendments of 1954, under which the maximum amount considered as "wages" is $4,200.00 a year.

[38] Mim. 5677, 1944 C.B. 320.

[39] I.T.'s 3685 and 3686, 1944 C.B. 324 and 326.

[40] Mim. 5717, 1944 C.B. 321.

[41] Except as otherwise indicated, most of these ideas were taken from Rev. Rul. 33, *op. cit.*, footnote 3, above.

1. Measure the benefits of participants by basic compensation, including overtime pay, if desired. The Treasury tends to look with disfavor upon the inclusion in such computations of bonuses, except possibly where they have been paid to all, or nearly all, the participants steadily for a substantial number of years, or where they are paid under a predetermined contractual arrangement.[42]

2. Prohibited discrimination may be effected by the allocation of forfeitures under profit-sharing plans. Methods of handling forfeitures that may be used include (a) allocation on basis of accumulated credits under the plan, (b) allocation on same basis as employer's contributions, and (c) use of forfeitures to reduce employer's contributions. Method (b) or (c) may be required in cases where it is thought that prohibited discrimination may result. However, for a liberal decision regarding the effect of the allocation of forfeitures, see *Ryan School Retirement Trust*, 24 T.C. No. 17 (1955).

3. The Treasury prefers that past service credits be computed on the average compensation during a five-year period (or lesser period of employment) preceding the establishment of the plan.

4. Vesting of employer contributions before the employee reaches retirement age or otherwise satisfies the requirements for obtaining benefits is not required unless it appears that failure to vest will effect a prohibited discrimination. Early vesting is ordinarily required in the case of employers having an abnormal number of employees for a relatively short time: for instance, incident to a defense contract. As a practical matter, vesting is much less likely to be required under a pension plan than under a profit-sharing plan. Some field representatives of the Treasury have arbitrary rules of thumb they apply to vesting under profit-sharing plans. Ultimate vesting (*e.g.*, at the time of retirement) is necessary in all plans, but this does not mean that benefits to a retired employee cannot be discontinued for good cause.

5. Where optional modes of payment of benefits are provided for under a plan, as, for example, payment in lump sum or in installments, there is no objection to providing that the retirement committee or the trustee may determine which method of payment shall be used. This presupposes that the benefits are fully vested in the employee, are approximately equal in value, and that the modes of payment applicable to key employees are not more favorable than those applicable to other employees.

6. The normal retirement age should be sixty-five, but may be lower if employees customarily retire at an earlier age in the particular company or business.

7. An employee must be allowed to retire and receive benefits when he reaches normal retirement age. However, provision may be made for continued participation and accumulation of benefits after normal retirement age. Under a pension plan, if benefits are not to continue to accumulate during continued employment after normal retirement age, specific provision should be made about the payment of his benefits, which may include: payment as though there had been actual retirement, deferment until actual retirement with no increment on account of the delay, or payment of the actuarial equivalent on actual retirement of the benefit at normal retirement age.

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[42] K. Raymond Clark, *Profit-Sharing and Pension Plans* (*Law and Taxes*), page 108. Chicago: Commerce Clearing House, Inc., 1946.

8. If a plan provides for a minimum service or age requirement for eligibility, the original participants should not be given past service credits for all prior service unless the subsequent participants are given the same credits. This rule does not apply if it can be shown that no prohibited discrimination results, or if the only eligibility requirement is a one-year waiting period.

9. A plan may contain provision for loans to a participant, but not to exceed the amount vested in him under the plan.

7. Qualification—Other Requirements

A plan must be a definite written program.[43] Much emphasis is placed by the Treasury on the clarity, definiteness and completeness of a plan. Definiteness will be fostered by carefully defining important terms that recur frequently in the plan, such as "compensation," "normal retirement date," "participant," "disability," and "net profits" (in a profit-sharing plan).

The plan must be communicated to the employees.[44] This means that the significant provisions of the plan relating to the rights and benefits of the participants must be made known to them. The Treasury has indicated that the best way of doing this is to furnish each employee with a copy of the plan. If this is not feasible, it will suffice if a booklet is delivered to the employees, or a notice is conspicuously posted on the employer's bulletin board, summarizing the plan in all of its essential features. The summary should include the type of plan that has been established, the eligibility requirements, a synopsis of all benefits, vesting provisions, whether employees are to contribute and, if so, the amount of contributions, and, if a profit-sharing or stock bonus plan, the employer contribution commitment, plus a statement that a copy of the complete plan is subject to inspection at a certain place on the employer's premises during specified times.[45]

Investments of trust assets must be for the exclusive benefit of the employees or their beneficiaries. Especial care must be exercised in making investments in stock or securities of the employer. The cost must not exceed the fair market value, a fair return should be provided, and there should be sufficient liquidity to permit distributions in accord with the terms of the plan.[46] Application should be made to the district director of internal revenue for advance approval of investments in stock or securities of the employer, lest a plan may be disqualified by such an investment which does not meet with Treasury approval. In any event, the Treasury requires that the appropriate district director of internal revenue be notified if investment is made in such stock or securities. Specified, detailed financial data about the employer company must accompany any such notification or application for approval.[47]

A new provision added by the 1954 Code was that an employee benefit trust will lose its exemption if it engaged in a "prohibited transaction."[48] Ordinarily, this would involve a transfer of money, property or services between the trust and the employer or a corporation controlled by the employer. Typical prohibited transactions might be the loan of trust funds to the employer without adequate security and a reasonable rate of interest, or buying or selling securities or other property between the trust and the employer for a price which is to the detriment of the trust. This new provision seems anomalous in view of the fact that common or preferred stock of the employer may be purchased without any requirement of security.[49] It also raises a question as to whether the employer may now obtain a deduction for contributing an unsecured promissory note, or one which does not bear a reasonable interest rate.[50]

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[43] Reg. 118, Sec. 39.165-1(a).
[44] *Ibid.*
[45] Rev. Rul. 33, *op. cit.*, footnote 3, above.
[46] *Ibid.*
[47] *Ibid.*; Rev. Rul. 32, 1953 I.R.B. No. 6, amended Rev. Rul. 54-172, 1954 I.R.B. No. 20.
[48] 1954 IRC Sec. 503.

Another new 1954 Code provision will subject an otherwise exempt trust to tax on income from the active conduct of a trade or business (including partnership income), or from a "business lease." [51] Briefly, a business lease is a lease of real property[52] with respect to which the trust-lessor is indebted at the end of the taxable year.[53] It must be a lease for more than 5 years, including extensions and renewals. A lease is treated as continuing for more than 5 years if it has been occupied by the same lessee for more than 5 years (commencing no earlier than the date the trust acquired the property). If the lease is a business lease, the rents received are taxed in the same proportion that the debt on the property bears to the adjusted basis of the property at the end of the taxable year. Therefore, after the debt is retired, the rents are not taxable.

The Treasury insists that a profit-sharing plan cannot qualify unless it contains a definite mathematical formula for fixing the profits to be contributed by the employer.[54] The courts, however, have held that no such formula is required.[55]

The Treasury has ruled that a plan providing death benefits may qualify even though the employees are not granted the unrestricted right to designate their own beneficiaries. In lieu of such unrestricted right, the plan itself may provide that the death benefit will be paid to the estate of the employee, or dependents of the employee, or persons who are the natural objects of the employee's bounty.[56] Presumably the employee could be given the right to designate beneficiaries himself within the indicated classifications. On the other hand, the Tax Court has indicated that the Treasury cannot properly put any limitations upon the provisions of a plan regarding the designation of beneficiaries, pointing out that the statute does not prescribe who shall be the employee's beneficiary or how one shall be named.[57]

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[49] But subject to the approval of the Treasury. See footnote 47, above.

[50] See discussion in Section 10 of the text.

[51] 1954 IRC Sections 513, 514.

[52] Also personal property if leased under or in connection with a lease of real property. 1954 IRC Sec. 514(d).

[53] Excluded from business lease indebtedness is any debt incurred before March 1, 1954, on real estate leased before that date or any debt incurred after that date which was necessary to carry out the terms of such a prior lease. Also excluded is a loan from a "brother" trust except to the extent that the other trust had to borrow to make the loan. 1954 IRC Sec. 514(c)(5) and (7).

[54] Reg. 118, Sec. 39.165-1(a).

[55] *The Lincoln Electric Company Employees' Profit-Sharing Trust, etc.* v. *Comm.* (6 Cir. 1951), 190 F. 2d 326, *no cert.; Produce Reporter Co.*, 18 T.C. 69 (1952), *non-acq.* 1952 I.R.B. No. 19, *aff'd* (7 Cir. 1953) 207 F. 2d 586; E. R. *Wagner Mfg. Co.*, 18 T.C. 657 (1952), *acq.*, 1953 Prentice-Hall Federal Tax Service par. 76,389. See also *Estate of H. S. Davis*, 22 T.C. No. 99 (1954).

[56] Rev. Rul. 54-398, 1954 I.R.B. No. 38.

Any kind of qualified plan (such as a profit-sharing or stock bonus plan or some types of money purchase pension plans) which provides for distributions in accordance with amounts credited to participants, must provide for a valuation of securities held in trust at least once a year, on a specified inventory date. Ordinarily, the securities should be valued at their fair market value.[58]

Where amounts to be distributed to participants under a profit-sharing plan are measured by earmarked investments (such as annuity or life insurance contracts), the trustee must invest each participant's interest under the plan proportionately, unless all participants have the right to direct the trustee about investments.[59]

With regard to the investment of funds of a profit-sharing trust in insurance contracts, the Treasury apparently registers no objection to the purchase of the higher-premium type of contract, such as a retirement income or endowment contract, so long as the premiums are kept within reasonable limits in relation to the amount allocated to the employee. However, the Treasury has ruled that the purchase of ordinary life insurance by such a trust must be incidental to the primary purpose of the plan.[60] It will be considered incidental where these two requirements are met:

1. The aggregate amount of premiums in the case of each participant is less than one-half of the aggregate contributions allocated to him at any particular time.
2. The plan requires the trustee to convert the policy at or before retirement to provide periodic income so that no portion of such value may be used to provide insurance protection after retirement.

It is all right for the trustee to own the policies, and apparently to be the policy beneficiary.[61]

A plan cannot qualify as a pension plan if the only retirement benefits which are provided are annuities stemming from the conversion of ordinary life insurance policies into annuities at the normal retirement date.[62]

A trusteed plan is required to meet certain technical requirements. The trust must be created or organized in the United States. The trust must be part of the plan,[63] and the trust agreement should so state. Although the trust instrument can and should reserve to the employer the legal right to amend or terminate the plan and trust, it must recite language making it affirmatively impossible (prior to the satisfaction of all liabilities to employees or their beneficiaries covered by the trust) for any part of the trust corpus or income to be used for or diverted to purposes other than for the exclusive benefit of such employees or beneficiaries.[64]

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[57] *Meldrum & Fewsmith, Inc.*, 20 T.C. 790 (1953), overruling P.S. 19, 1944 Prentice-Hall par. 66,364, *acq.*

[58] Rev. Rul. 33, *op. cit.*, footnote 3, above.

[59] *Ibid.*

[60] Rev. Rul. 54-51, I.R.B. 1954-8.

[61] *Id.*

[62] Rev. Rul. 54-67, I.R.B. 1954-8.

[63] Reg. 118, Sec. 39.165-1(a).

[64] Reg. 118, Sec. 39.165-2.

See Section 16 of this chapter regarding the requirement that a plan should be permanent.

8. Qualification—Time Leeway

A newly created plan may, if necessary, be amended[65] to meet the qualification requirements at any time up to and including the fifteenth day of the third month following the end of the employer's taxable year in which it was created, provided the amendments are made retroactive to the date the plan was established.[66] This period gives an employer who establishes a plan at or near the end of a taxable year time within which to obtain the formal or informal opinion of the Treasury field representative as to any amendments required to obtain Treasury approval of the plan, and to be guided accordingly.

9. Method of Obtaining Initial Treasury Approval of Plan

An employer who intends to establish a plan should act well in advance of the end of the taxable year in which he expects to put the plan into effect. Such action will afford opportunity to consider carefully the terms of the plan, to make cost determinations, and to have the necessary instruments drafted. An important feature is that it will allow the employer to take advantage of a beneficent practice of the Treasury. This consists of issuing a ruling in advance of the adoption of a plan by a taxpayer, with a decision as to whether it will meet the qualification requirements.[67]

The Regulations specify the instruments and data that are to be submitted in connection with an initial request for a determination letter with respect to a plan, whether a proposed or an adopted one.[68] Submissions should be in duplicate. Such request is filed with the appropriate district director of internal revenue, ordinarily the director for the district where the principal place of business of the employer is located.[69] Depending upon the circumstances, the office of the director usually does one or more of the following things: (1) issues a letter stating that the plan qualifies (or will qualify if adopted), (2) sets an informal conference in his office for discussion of the plan, (3) writes the employer or his representative specifying certain amendments that he thinks should be made in order that the plan may be approved. Field determinations on established plans are subject to post review in Washington. However, there is no review in Washington of all qualification letters. A sampling process is used. Letters adverse to qualification are more apt to be reviewed than favorable ones. In the absence of a misrepresentation or omission of material facts, a favorable field determination involving a plan which has been put into effect, a contribution made and announced to the employees, will not be reversed on post review. Except in most unusual circumstances a favorable field determination can be regarded as final.

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[65] Except as to technical requirements set out at the end of Section 7 of the text.

[66] Section 162(d)(2)(B), Rev. Act of 1942, as amended; 1954 IRC Sec. 401(b). This refers to plans created after December 31, 1944. The time leeway is important because the employer's deduction right (except where interests of employees in contributions are nonforfeitable) depends upon the plan's qualifying by the end of the employer's taxable year, and upon its qualifying during its existence during that year. See, however, cases cited at end of footnote 80 below.

[67] Field rulings are now termed "determination letters." Rev. Rul. 54-172, *op. cit.*, footnote 47, above. The formerly permitted practice of adopting a plan and making a contribution conditioned on the approval of the plan by the Commissioner was discontinued after March 1, 1945. P.S. No. 47, 1945 Prentice-Hall par. 76,129. See further P.S. No. 68, 1951 Prentice-Hall par. 76,270 issued in view of the Wage and Salary Stabilization requirements under the Defense Production Act of 1950.

[68] Reg. 118, Sec. 39.23(p)-2.

[69] Rev. Rul. 32, *op. cit.*, footnote 47, above.

10. Deduction of Employer Contributions Under Qualified Plans—General Requirements

An employer contribution under a qualified plan is not deductible under Section 404 of the law unless it would be deductible as an ordinary and necessary business expense under Section 162.[70] Principally, this means that the contribution for each participant must not exceed the amount that, together with other deductions allowed for the participant's services, constitutes reasonable compensation for services rendered.[71] The Regulations make it clear that, in deciding what is reasonable compensation for this purpose, there are to be considered not merely contributions, compensation, and services for the particular taxable year in question, but all of such factors for all prior years, and the current year.[72] Under a test like this, it seems doubtful that many contributions will be disallowed.

A contribution is generally deductible only in the year in which it is paid, whether or not the employer is on the accrual basis.[73] An important exception permits an accrual basis employer to accrue a contribution as of the last day of the employer's taxable year and to deduct it, within the applicable limits as to amount, if actually paid by the due date for filing the income tax return of the employer for the taxable year.[74] This includes extensions of time for filing the return. Prior to an amendment made by the 1954 Code, the contribution had to be paid within 60 days after the end of the taxable year.[75] Under this prior rule, it was held that the payment of a contribution on the 61st day was timely where the 60th day was a legal holiday in the state of the employer's residence.[76]

A difference of opinion exists as to whether it is sufficient payment of a contribution under a pension or profit-sharing plan to deliver the employer's promissory note. The Tax Court has held such a note not to be payment, and has been affirmed in this by the Court of Appeals for the Seventh Circuit.[77] The Tax Court maintained this position despite the fact that the pension board requested the employer to issue an interest-bearing promissory note so that the trust would have an immediate income-producing investment.[78] However, the Court of Appeals for the Third Circuit has reversed the Tax Court in two cases, holding the note of a solvent employer to be payment to the extent of its fair market value.[79]

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[70] Or as an expense for the production of income under 1954 IRC Sec. 212.

[71] Reg. 118, Sec. 39.23(p)-1. See *The Charles E. Smith & Sons Co.*, Prentice-Hall T.C. Memo. Decision par. 47,128, affirmed (6 Cir.) 184 F. 2d 1011. It also means that a personal expense cannot be deducted. For instance, a home owner could not set up a plan for his domestic servants and deduct contributions thereunder.

[72] Reg. 118, Sec. 39.23(p)-1(a).

[73] *Logan Engineering Co.*, 12 T.C. 860 (1949), affirmed and dismissed (7 Cir. 1949), 1949 Prentice-Hall par. 71,135.

[74] 1954 IRC Sec. 404(a)(6). Another exception to the general rule is a carry-over of an excess contribution. See text discussion in Sections 11 and 12 of this chapter.

[75] 1939 IRC Sec. 23(p)(1)(E).

[76] *Campbell Chain Co.*, 16 T.C. 1402 (1951), *acq.* 1951-2 C.B. 2.

[77] Footnote 73, above.

It is important to keep in mind that certain legal requirements must be met by the end of the first taxable year for which a deduction is claimed under a qualified plan. A qualified plan must be adopted by the end of the taxable year. If the plan is to be trusteed, a valid trust must be created within the year. This involves the execution of a written trust instrument in adequate form and—this is very important—the making of a payment to the trustee in an amount sufficient at least to make the trust a valid one under local law.[80] If the plan is to be a non-trusteed annuity plan, the following steps, in addition to the adoption of the plan, shall be undertaken before the close of the taxable year: (1) application for the annuity contract or contracts, (2) acceptance of the application by the insurance company, (3) preparation of the contract or contracts, or abstracts thereof, in adequate detail, and (4) remittance on account of the premiums. This holds provided the contract or contracts are executed and issued within a reasonable time.[81]

11. Deduction of Employer Contributions—Qualified Pension Plans

The rules that apply to the deduction of contributions under qualified pension plans are concerned mainly with the actuarially determined cost of the pension benefits.

In the exercise of the broad discretion conferred upon the Commissioner by the law, certain general requirements have been prescribed for determining pension costs.[82] Mortality and interest must be discounted in advance. In proper cases, discount or recognition may be made in advance for expected withdrawals, changes in compensation, and retirements at various ages. A properly weighted retirement age should be used. Recognition may be accorded to different classes of risks. The assumptions and methods must be reasonable in the light of the circumstances. Adjustments shall be made for experience more favorable than previously assumed.

The specific deduction rules are known by their clause letters under Section 404(a)(1) of the law; clauses (A), (B) and (C).

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[78] *Mary Sachs,* 1952 Prentice-Hall T.C. Memo. Decision par. 52-256; *Slaymaker Lock Co.,* 18 T.C. 1001 (1952); both cases reversed (3 Cir. 1953) 208 F. 2d 313, *no cert.*

[79] Footnote 78, above.

[80] See Mim. 6394, 1949-1 C.B. 118. The former 60-day rule lulled some employers into believing that it was not necessary to make any contribution to a trust within the first taxable year, so long as a contribution was made within the 60-day period. In P.S. No. 55, 1946 Prentice-Hall par. 76,078, it was ruled that no deduction was allowable in such a case, since under the local law a corpus was necessary to the creation of a trust. The furor created by this ruling was abated by Mim. 5985, 1946 Prentice-Hall par. 76,113, which made the ruling inapplicable to taxable years ending on or before February 28, 1946. In this regard, two decisions of the Tax Court have thrown doubt upon the position of the Treasury. *555 Inc.,* 15 T.C. 671 (1950), *non-acq.,* 1951-2 C.B. 5, affirmed and dismissed (8 Cir., 1951) 192 F. 2d 575; *Crow-Burlingame Co.,* 15 T.C. 738 (1950), *non-acq.,* 1951-2 C.B. 5, affirmed and dismissed (8 Cir., 1951) 192 F. 2d 574. But see *Abingdon Potteries, Inc.,* 19 T.C. 23 (1952).

[81] Mim. 6020, 1946-1 C.B. 74.

[82] Reg. 118, Sec. 39.23(p)-4. The Treasury has also published a kind of actuary's guide in the form of a Bulletin on 1939 IRC Sec. 23(p)(1)(A) and (B).

Clause (A), though hardly generous in its allowance, minimizes the necessity for actuarial calculation. For the first taxable year for which an employer claims a deduction under a pension plan, he may contribute and deduct, without actuarial support, up to 5 per cent of the compensation of the participants for that year. The maximum limit remains the same in subsequent years unless the Commissioner finds that it is excessive. To enable the Commissioner to determine the reasonableness of the limit the employer is required to submit actuarial certifications for the second taxable year for which a deduction is claimed and for each fifth year thereafter. It is doubtful that clause (A) alone serves much useful purpose in the law, except possibly as a stopgap, since 5 per cent of compensation will hardly provide an adequate pension where past services are a factor.

Clause (B) permits the deduction of the excess of costs not deductible under the preceding clause. Such costs may be distributed as a level amount or a level percentage of compensation over the remaining future service of each participant. Although this clause may be relied upon with respect to any of the conventional methods of funding pension plans, it is mainly applicable to level premium plans, such as individual policy and group permanent plans. In these insured cases, insurance company costs are usually accepted.

Clause (C) permits the deduction of the "normal cost" for the year, plus an amount not exceeding 10 per cent of the past service cost. This clause is in common use under group annuity plans and wholly invested plans. As a practical matter, the allowable deduction is usually determined by the insurance company or the independent actuary, as the case may be, and the employer is advised accordingly.

As applied to a pension plan under which retirement benefits are provided through annuity or insurance contracts without a trust, there is an additional limitation that any refunds or premiums (for example, dividends, surrender values) shall be applied in the current or next succeeding taxable year toward the purchase of such retirement annuities.[83]

If in a given year the employer contributes amounts in excess of the maximum amount deductible, the excess may be carried forward and deducted in the succeeding year or years in which less than the maximum deductible amount is contributed.[84] However, the fact that less than 10 per cent of the past service cost was contributed and deducted in prior years will not permit the deduction of more than 10 per cent of such cost in a particular year.[85]

12. Deduction of Employer Contributions—Qualified Profit-Sharing Trusts

The maximum amount deductible on account of contributions made to a qualified profit-sharing trust for a particular taxable year of the employer is 15 per cent of the compensation otherwise paid or accrued to all participants under the plan during such year.[86]

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[83] 1939 IRC Sec. 23(p)(1)(B), 1954 IRC Sec. 404(a)(2). See P.S. No. 45, 1945 Prentice-Hall par. 76,101, as to permissible application of dividends under trusteed plans.

[84] 1939 IRC Sec. 23(p)(1)(A)(iv), 1954 IRC Sec. 404(a)(1)(D). In case of a tax-free liquidation of a subsidiary or a tax-free reorganization, the 1954 Code, Section 381(c)(11), provides for a carry-over deduction to the acquiring or succeeding corporation.

[85] P.S. No. 36, 1944 Prentice-Hall par. 66,397.

If the amount of the employer's profits to be used as the basis for the contribution cannot reasonably be determined within 60 days after the close of the taxable year of accrual, an estimate of such profits, determined in accordance with established accounting principles, and certified by the accounting or other responsible officer of the employer, may be used in determining the amount of contribution to be made.[87]

A "credit carry-over" is created where less than the 15 per cent limit is contributed for a particular taxable year.[88] This carry-over may be utilized as a deduction in succeeding years, in order of time, in which more than the 15 per cent limit applicable to any such year is contributed. This is subject to an over-all limit that the total deduction allowable in any such succeeding year cannot exceed 30 per cent of the aggregate compensation of the participants in such suceeding year.[89]

A "contribution carry-over" is created when more than the maximum amount allowable as a deduction is contributed for a particular taxable year. The aforementioned maximum amount allowable as a deduction includes any amount allowable as a deduction by reason of a credit carry-over.[90] The excess is deductible in succeeding years in order of time in which less than 15 per cent of the compensation of the participating employees in any such succeeding year is contributed, but the total deduction (including the contribution carry-over) in the succeeding year may not exceed such 15 per cent of the compensation.[91]

It should be noted that no contribution carry-over may be created, nor may a credit carry-over be utilized, if the contribution formula itself incorporates the statutory 15 per cent limit (for example, lesser of 10 per cent of profits or 15 per cent of compensation). In deciding upon a contribution formula, thought might be given either to eliminating reference to any statutory limit (that is, basing contributions only on profits), or to providing that the contribution shall be the lesser of a certain percentage of profits or the maximum amount deductible for the taxable year under the first and second sentences of Section 404(a)(3)(A).[92]

Reference has been made under Section 7 of this chapter to the position of the Treasury and the courts with regard to the necessity of a definite formula under a profit-sharing plan. While the courts hold that a plan does not need a definite formula to qualify, the Tax Court holds that if a plan contains a definite formula the employer is bound by the formula commitment and that an excess contribution is not deductible.[93] Consistent with this holding and with its general position on the formula question, the Treasury says that a contribution in excess of that called for by a formula is not deductible either for the year for which made or for any later year, being a voluntary payment and not an ordinary and necessary business expense.[94]

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[86] 1939 IRC Sec. 23(p)(1)(C), 1954 IRC Sec. 404(a)(3)(A). Nor may a deduction exceed the amount required by the contribution formula. *Wooster Rubber Co.*, 14 T.C. 1192 (1950), reversed on other grounds (6 Cir. 1951) 189 F. 2d 878. However, the Ninth Circuit has held, reversing the Tax Court, that an employer can deduct its entire contribution (up to the statutory limit) even though it exceeds the amount called for by the contribution formula set out in the plan. *McClintock-Trunkey Co.* v. *Commissioner*, (9 Cir. 1954) 217 F. 2d 329, *reversing* 19 T.C. 297.

[87] P.S. No. 46, 1945, Prentice-Hall par. 76,117. This ruling will probably apply under the new Code, Sec. 404(a)(6).

[88] Mim. 6131, 1947-1 C.B. 21.

[89] Reg. 118, Sec. 39.23(p)-10. In some instances, the limit in a particular year may be less than 30 per cent. See the regulations cited in this footnote.

[90] Mim. 6131, footnote 88 above.

[91] 1939 IRC Sec. 23(p)(1)(C), 1954 IRC Sec. 404(a)(3)(A) (third sentence). A carry-over may be used only in a year when the trust qualifies. *South Chester Tube Co.*, 14 T.C. 1229 (1950).

[92] See Mim. 6131, footnote 88 above.

A beneficent deduction provision was enacted in the 1954 Code applicable to affiliated corporations which have a common profit-sharing plan.[95] If any member of the group is prevented from making a contribution because it has no current or accumulated earnings or profits or because the earnings or profits are less than the contribution which otherwise would be made, the other members of the group which have profits may contribute in behalf of the loss or deficient member. If a consolidated return is not filed, the profitable members must divide up the contribution in the proportion that their respective current and accumulated earnings or profits (determined after deduction of its own contribution but before deduction of the contribution for the loss member) bear to such earnings or profits of all the profitable members. Each contributing member may deduct the contribution it makes.[96] In determining a credit carry-over of the loss member, contributions made by the other members are treated as if made by the loss member. This new deduction provision may well call for amendments of contribution formulae of affected plans to fit in with its terms. Under a conventional formula related to the separate profits of each member, it may be impossible to determine the amount of contribution which the loss or deficient member "would otherwise have made under the plan."

13. Deduction of Employer Contributions—Combinations of Plans

If an employer has a combination of two or more qualified plans, as, for example, a pension plan and a profit-sharing plan, the total amount deductible for a taxable year is subject to a limit of 25 per cent of the compensation otherwise paid or accrued during the taxable year to the employees who are covered by the plans.[97] This does not mean that only the compensation of employees covered by both or all plans is taken into account. The compensation of each employee covered by any plan is taken into consideration, although, of course, it is included but once in arriving at the total compensation. The 25 per cent limit is an over-all one, and is applied after the limits applicable to each separate plan are applied. Carry-overs are also provided for with respect to contributions in excess of the 25 per cent limit, to be applied to succeeding years in order of time, and when applied the deduction cannot exceed 30 per cent of the compensation of the covered employees.[98]

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[93] See footnote 86, above.

[94] I.T. 4055, 1951-2 C.B. 30.

[95] 1954 IRC Sec. 404(a)(3)(B).

[96] The deduction is subject to the 15 per cent limit of Section 404(a)(3)(A), and each contributor is limited to an amount not exceeding its current or accumulated earnings or profits.

[97] 1939 IRC Sec. 23(p)(1)(F), 1954 IRC Sec. 404(a)(7); Reg. 118, Sec. 39.23(p)-12.

14. Recurrent Requirements

Having established that a plan is qualified does not relieve the employer and the trustee (of a trusteed plan) from meeting certain annual filing requirements to substantiate the deductibility of employer contributions and the exempt nature of the trust. The requirements applicable to the employer are explained in Reg. 118, Section 39.23(p)(2) and those applicable to the trustee are set forth in Section 39.165-1(c) of the same regulations.

The employer must file with the district director of internal revenue[99] with whom his returns are filed complete information for the first taxable year with respect to which a deduction is claimed for a contribution under a profit-sharing or pension plan. This must be done despite the fact that the same or similar information was previously filed with the director in applying for a ruling. Some of the information must accompany the return, but other information may be filed within 12 months after the end of the taxable year covered by the return. Some of the information need be filed only once, provided a statement is filed each year stating that no change has been made. Once a change is made, a report reflecting the altered situation must be filed. Certain of the data with respect to the 25 highest paid employees covered by the plan may be confined to employees owning, directly or indirectly, more than five per cent of the employer's voting stock, after such data have been filed for two consecutive years. In view of the varying rules as to the time of filing and as to what must be filed, it is recommended that forms on which the information is to be supplied be prepared in separate sections or parts that may be accommodated to the filing requirements.

The filing requirements applicable to the trustee are much simpler than those applying to the employer, since the trustee can satisfy the bulk of the requirements by obtaining annually from the employer and filing with the Commissioner a notification that the information necessary to establish the exempt nature of the trust has been filed by the employer, together with certain identifying information, and a request for exemption of the trust.[100]

It is not at all unusual for a previously qualified plan to be amended. The plan as amended is again subject to Treasury approval. In order to avoid an amendment, the adoption of which may unwittingly disqualify a plan, proposed amendments should be submitted to the district director of internal revenue. Some Treasury rulings may require amendment of existing plans, as to which see P.S. No. 35 (revised).

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[98] Goodman, *op. cit.*, footnote 1, above, page 237.

[99] Rev. Rul. 32, *op. cit.*, footnote 47, above.

[100] See 1954 IRC Sec. 6033. The trustee is required to file annually form 990-P, prescribed by the Treasury under the 1954 Code.

15. How Employees or Beneficiaries Are Taxed Under Qualified Plans

Event	*Type of Plan*	*Method and Extent of Taxation*
(1) Retirement	Any noncontributory	Employee includes in taxable income all amounts received or made available.[101]
(2) Retirement	Any contributory	Employee excludes from income each year an amount equal to the total of his contributions divided by the number of years the annuity is to be payable (i.e., his life expectancy if a life annuity or a fixed number of years if an annuity for a term certain); balance received is included in income.[102] However, if the total amount he will receive within the first 3 years will equal or exceed his contributions, all amounts received are excluded until the contributions are recovered.[103]
(3) Termination of service	Any	Rule 1 or rule 2 applies, except where total benefits are paid within one taxable year of the employee, the excess of the distributions over his contributions, if any, is taxed as a long-term capital gain. Where stock or securities of the employer (or its subsidiary) are distributed, any unrealized appreciation in the value thereof is not taxed.[104]
(4) Death, including termination of service by death and death after termination of service.	Any	Beneficiary taxed in same manner as employee would have been taxed, except that life insurance benefits are exempt.[105] Moreover, benefits paid by reason of the death of the employee are exempt up to $5,000.[106]
(5) Payment of cost of life insurance protection with employer contributions or trust earnings — proceeds payable to employee's beneficiary.	Any	One year term cost of life insurance protection, based on rates of issuing insurance company taxable as current income to employee in year cost is paid.[107]
(6) Distribution of annuity contract.	Any trusteed	Cash surrender value not taxable until contract surrendered. Rule does not apply to retirement income contract or other contract with life insurance element.[108]

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[101] 1939 IRC Sections 22(b)(2)(B) and 165(b), 1954 IRC Section 402. If paid within one taxable year of employee, the long-term capital gain provision applies; and if stock or securities of the employer are distributed, unrealized appreciation thereon is not taxed. See rule 3 below. For definition of "made available," see Rev. Rul. 54-265, 1954 I.R.B. No. 27, and Rev. Ruls. 55-423, 424, and 425, 1955 I.R.B. No. 26.

[102] 1954 IRC Secs. 402, 403 and 73. This is an oversimplified statement of the law. The statutes should be checked for details.

[103] 1954 IRC Sec. 72(d).

[104] 1939 IRC Sec. 165(b), 1954 IRC Sec. 402(a)(1), (2), (3); Reg. 118, Sec. 39.165-6(b).

The 1954 Code added an income tax credited based on retirement income.[109] An individual who has attained age 65 before the end of his taxable year and who receives pension or annuity income may take a credit at the lowest tax rate (now 20 per cent) on such income up to $1,200. There are, however, certain limitations and possible modifications of this general rule:[110]

> He must have received in each of any 10 previous calendar years (not necessarily consecutive) earned income of more than $600.
>
> Any Social Security pension or other pension or annuity otherwise excluded from gross income is deducted from $1,200 in computing the base for the credit.[111]
>
> If he has not reached age 75 before the end of the taxable year, any amount of earned income in excess of $900 received by him during the year is likewise deducted from $1,200.

The maximum credit allowable is $240 on the basis of present tax rates. The effect is to allow a qualified married person with no dependents (who files a joint return with his spouse and uses the standard deduction) to receive tax-free a maximum of $4,000 of annual retirement income.[112]

16. Termination of Plans

When can a qualified plan be terminated without tax penalties?[113]

Under a contributory plan, even though such stock or securities are distributed while the employee is still in the employment of the employer, that portion of the unrealized appreciation which is attributable to the amount considered to be contributed by the employee to the purchase of such stock or securities is excluded from taxable income.

[105] 1939 IRC Sec. 22(b)(1), 1954 IRC Sec. 101(a)(1); Reg. 118, Sec. 39.165-6. However, except to the extent affected by the $5,000 exemption referred to in the text, only the excess of face amount over reserve of retirement income policy is exempt if employee dies before maturity of policy while covered by plan. I.T. 3993, 1950-1 C.B. 75.

[106] 1939 IRC Sec. 22(b)(1)(B), 1954 IRC Sec. 101(b); Reg. 118, Sec. 39.22(b)(1)-2.

[107] Reg. 118, Sec. 39.165-6; P.S. No. 58 (revised), 1947 Prentice-Hall par. 76,102. The Treasury has ruled that the one-year term cost is likewise taxed to the employee under a qualified, non-trusteed group permanent plan. P.S. No. 65, Prentice-Hall Pension and Profit-Sharing Service, par. 9564. Likewise, the cost of group insurance purchased under a qualified plan is taxable to the participants. Rev. Rul. 54-52, I.R.B. 1954-8. Under a contributory plan, it may be provided that the employee's contributions shall be first applied to the cost of life insurance protection. P.S. No. 32, 1944 Prentice-Hall par. 66,376.

[108] Reg. 118, Sec. 39.165-6. Where life insurance element is involved, the part of the value of the contract which can be applied to continued insurance protection is taxable at the date of distribution. Mim. 6461, Prentice-Hall Pension and Profit-Sharing Service, par. 9275; P.S. No. 66, Prentice-Hall Pension and Profit-Sharing Service, par. 8565.

[109] 1954 IRC Sec. 37. The statute refers to "pensions and annuities," interest, rents, dividends, and, in the case of an individual under 65, pensions and annuities from a public retirement system—in all cases to the extent included in gross income. The author believes that the words "pensions and annuities" are intended to include periodic retirement payments from a profit-sharing trust.

[110] Section 37 does not apply to an individual who elects to use the "short form" return and to have the tax computed by the Commissioner under Section 6014.

[111] Amounts excluded from gross income under Section 72 (relating to annuities), Section 402 or Section 403 (relating to taxation of beneficiaries of employee trusts or employee annuities) are not deducted from the $1,200, since they represent in effect a return of capital or tax-free proceeds of a like nature. Report of Senate Finance Committee, page 166.

[112] *Id.*, p. 167.

[113] See in general, Byron Harrill, and Samuel A. Miller, "Tax Implications of Terminations of Pension Plans," *Taxes*, March 1949, Vol. 27, page 191.

The Regulations sound the key principles:[114] A plan should be permanent. If it is abandoned for any cause other than business necessity within a few years[115] after it was established, this abandonment will be evidence that it was not originally intended to be permanent. Especially suspect are pension plans that are abandoned soon after pensions are fully funded for key employees. The permanency of a plan will be indicated by all of the surrounding circumstances including the likelihood of the employer's being able to continue the contributions as provided under the plan.

The permanency provisions of the Regulations were designed to place some restriction on setting up a plan during high profit years to secure a tax advantage, only to abandon the plan in a few years when profits drop off.[116]

"Business necessity" has been strictly construed by the Treasury. It includes insolvency, bankruptcy, or adverse business conditions beyond the employer's control which make it unreasonably burdensome to continue the required contributions under the plan.[117] It may also include a change of ownership in an arm's length transaction or a bona fide and substantial change in stock holdings and management.[118] Furthermore, the change that constitutes business necessity must not have been reasonably foreseeable at the inception of the plan.[119]

The existence of business necessity, as defined, justifies the termination of a plan. The absence of business necessity is evidentiary only. It creates the presumption that the plan was not intended to be permanent when it was established. This presumption it is the employer's burden to overcome. The practical operations of the plan from its inception will be carefully examined by the Commissioner, and the burden of overcoming the presumption will be especially heavy if the plan was discriminatory in operation or if the effect of the termination itself will be discriminatory. The inclusion of provisions required by Mimeograph 5717 does not guarantee against a finding that a plan was discriminatory in operation, but it may relieve the evidentiary burden.[120] Moreover, a condition of a favorable ruling on termination may be a reallocation of benefits so as not unduly to favor highly paid employees who were near retirement age at the inception of the plan.[121]

The permanency requirements specified by the Treasury apply equally to the curtailment of a plan. Curtailment includes the reduction of benefits, the reduction of employer contributions, the making of eligibility or vesting requirements less liberal to employees, and the requiring of employee contributions to provide benefits that formerly were exclusively provided by employer contributions.[122]

The principles stated above are those advocated by the Treasury. Recent cases have cast serious doubt upon them. In considering the Lincoln Electric Company profit-sharing plan for the third time—this time on the question of the exemption of trust income under Section 165(a)—the Court of Appeals for the Sixth Circuit held the trust exempt even though only one lump sum contribution was made by the employer and no provision was made for future contributions.[123] The Treasury urged, and a majority of the Tax Court held, that the trust failed for exemption in that it did not satisfy the definite formula or permanency requirements of the Regulations. The Court of Appeals undertook to find that the trust met those requirements within a proper interpretation of the Regulations, but held that if the Regulations should bar exemption, they were invalid.

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[114] Reg. 118, Sec. 39.165-1(a).

[115] The words "within a few years" have not been elaborated upon. It is thought, in view of the use of a ten-year period in Mim. 5717, that it will be construed to mean "within ten years," with the possibility that any amendment substantially affecting contributions or benefits may be considered as the establishment of a new plan.

[116] P.S. No. 7, 1944 Prentice-Hall par. 66,332.

[117] *Ibid.*

[118] Mim. 6136, 1947-1 C.B. 58.

[119] P.S. No. 52, 1945 Prentice-Hall par. 76,280.

[120] *Ibid.*

[121] Mim. 6136, footnote 118, above.

[122] *Ibid.*

In the case of *E. R. Wagner Mfg. Co.*,[124] it appeared that the employer in 1946 cut down the percentage of profits to be contributed under its profit-sharing plan from 35 per cent to 10 per cent. The 35 per cent formula had been put in the plan in 1944 after the Commissioner refused to approve a formula providing for contributions of "at least 10 per cent" of profits. The Commissioner retroactively disallowed deductions on the ground that the change contravened the permanency and definite formula provisions of the regulations. He argued to the court that the employer intended from the start to limit its contributions to 10 per cent, that the plan was not to benefit employees but to avoid excess profits taxes, and that hence the plan was disqualified. Not so, replied the Tax Court. The statute does not require either a formula or a permanent plan. Be that as it may, the plan had a formula and it was permanent. A plan is permanent if the contributions are irrevocable and if the plan must continue until the beneficiaries receive the trust funds. The employer was justified in reducing the percentage of profits required to be contributed in view of the removal of the excess profits tax and the fact that the employer's quick assets had fallen below current liabilities. Reasonable changes in formulae should be permitted as conditions change.

If a plan is terminated or curtailed within a few years, and if it is held that the plan was not intended to be permanent from the start, the tax penalties are those that flow from retroactive disqualification of the plan. These penalties are (subject to the statute of limitations) disallowance of employer's contributions; if a trust, the taxation of the trust income; and if employees' rights were vested, or non-forfeitable, individual liability for income taxes.

Before termination or curtailment of a plan, an employer should certainly take advantage of the privilege of obtaining a Treasury determination letter in advance as to whether the plan will be retroactively disqualified.[125] It may well be that a determination can be obtained in conformity with the employer's wishes, or that some relatively minor change in the proposal will result in a favorable determination. Upon termination or curtailment, the trustee should notify the district director of internal revenue and await his advice before distributing any assets.[126]

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[123] Footnote 55, above.

[124] *Ibid.*

[125] See P.S. No. 60, 1947 Prentice-Hall par. 76,198, for information to be submitted.

[126] P.S. No. 56, 1946 Prentice-Hall par. 76,210. See also Rev. Rul. 33, *op. cit.*, footnote 3, above.

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Deferred Compensation Contracts

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1. Points to Consider

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2. Deferred Compensation Contracts

Deferred compensation contracts are contracts under which part of the compensation for current services is paid in some later tax year. Contracts are usually arranged primarily or solely for the benefit of persons rendering services, either as an employee or as independent contractors. Executives, top salesmen, and highly paid entertainers are the usual types of employees having such contracts. Deferred compensation contracts with independent contractors cover a wide variety of services. Professional entertainers are the most prominent in this field, although such contracts are also used in such diverse lines of business as investment banking, engineering, and the insurance business. As a matter of convenience, the person or firm rendering the services will hereafter in this chapter be referred to as the "employee" although the term will be used as applying to independent contractors as well as employees. Arrangements which qualify for special treatment, as employees' pension or profit-sharing trusts,[1] and stock options and stock sales, will not be discussed in this chapter as they are treated in full elsewhere in this volume.

3. Principal Advantages and Disadvantages

The obvious purpose of deferred compensation contracts is generally to enable the person furnishing the services to report his income in subsequent tax years when he expects to be in lower income tax brackets. The top income tax brackets are so high that there is naturally a strong urge to defer the receipt and taxation of the part of his compensation which is in the high tax brackets. Very little can be lost by such a deferment, and there is the probability that at some later year he will be in lower tax brackets. In comparatively rare instances, the employee may wish to have such a contract as a matter of security, because of a fear that amounts he currently receives may be dissipated or lost by the time his earning power has gone and that he would be better off with an assured income for his later years. Some of the obvious disadvantages to the employee are that he does not currently receive the full compensation from his services; that the purchasing power of the dollar has over long periods of years decreased and he is therefore likely to be paid off in dollars having less purchasing power; and he is taking a credit risk on the employer being financially able to pay him at the payment dates. In some cases, it may not be certain that the employee will be in lower tax brackets when the payments become due.

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[1] 1954 IRC § 401; 1939 IRC § 165.

From the standpoint of the employer, the principal advantage is that, by offering something which the employee considers highly desirable, it is either able to secure services it otherwise could not get, or is securing the services at a lower price than it would otherwise have to pay. The employer also has an advantage in that the money is not payable until some future date, and the employer therefore retains the use of these funds in its business. The big disadvantage of such contracts to the employer is that the compensation is not deductible for tax purposes until it is paid.[2] Therefore, a substantial part of the cash not paid to the employee must be paid out almost immediately in taxes and, if the employer is proceeding on a sound basis, the future liabilities to the employees on such contracts should be kept in mind regardless of whether there are any reserves set up on the balance sheet.

4. The Deferment of Income Tax of the Employee

Since the principal purpose of deferred compensation contracts is to defer the income tax on current earnings to some later year or years, it is all-important that the contract should in fact have this tax effect. Generally, a taxpayer reporting on the cash basis reports his income for tax purposes when the money is received. Two important exceptions to this general rule are the "equivalent of cash" doctrine and "constructive receipt." Both of these exceptions are based upon the general provisions of the Code which defines gross income as including all income from whatever source derived.[3] As might be expected when the statutory provisions are so indefinite, the scope of these exceptions to the general rule has not been precisely determined. However, it is clear that certain types of contract provisions must be avoided and others are sufficiently doubtful that it is desirable not to incur the risks involved until either the law becomes more settled or a favorable attitude by the Internal Revenue Service eliminates the present dangers.

The usual examples of the application of the "equivalent of cash" doctrine are cases in which something has been purchased or otherwise set apart with a third person for the benefit of the employee or where he has received something of value. Thus, employees have been held taxable on premiums paid for annuity contracts in which the employee's interest was non-forfeitable, even though the employee did not receive the annuity contract or the contract was not assignable and had no cash surrender value.[4] Also, non-forfeitable contributions to a trust which does not qualify under the Code are taxable to the employee at the time the contributions are made, even though there is no way in which the employee can get any present benefit or enjoyment from his interest in the trust.[5] These cases and the Code[6] make it clear that, if payments are made to any third party for the ultimate benefit of the employee, such payments will be immediately taxable to the employee unless his interest is forfeitable.

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[2] 1954 IRC § 404(a)5; 1939 IRC § 23(p)(1)(D).

[3] 1954 IRC § 61; 1939 IRC § 22(a).

The disadvantages of payments to a third party with the employee's interest forfeitable are practically prohibitive. The employee is not likely to be interested in having money set aside for him if his interest therein may be forfeited by a real contingency, and the fund may be taxable to him in full in one year, when his interest vested.[7] The employer faces the possibility of not getting a tax deduction either at the time the payment is made by the employer[8] or at the time the funds are distributed to the employee.[9] Therefore, the employee must rely on the financial ability of the employer to make the deferred payments at the time they come due. In the case of the usual large corporation, this will not involve any great risk. However, the risk could be so great, if the employer was in a hazardous line of business and was not financially strong, that a deferred compensation contract would be undesirable.

The basic principle of the doctrine of constructive receipt is set forth in the Regulations[10] which provide that income which is available to the taxpayer without any substantial limitation as to the time or manner of payment will be deemed to have been constructively received. This principle has not been extended to situations where the employee contracts prior to the date when payment is due, that he be paid for his services at a later date. The reason for this is that he never had a right to receive the compensation at any time prior to actual payment. Therefore, the income was never available to the employee and there was no constructive receipt. Whether a contract could have been made under which the income would have been available is beside the point. It is not a question of what kind of a contract could have been made. The question is whether the money was available under the contract actually entered into.

The leading cases on this point involve an employee named *Howard Veit.*[11]

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[4] *Renton K. Brodie,* 1 T.C. 275 (1942); *Hackett* v. *Commissioner* (1 Cir. 1946), 159 F. 2d 121, 35 AFTR 637; *Hubbell* v. *Commissioner* (6 Cir. 1945), 150 F. 2d 516, 34 AFTR 42; *Oberwinder* v. *Commissioner* (8 Cir. 1945), 147 F. 2d 255, 33 AFTR 654; *U.S.* v. *Drescher* (2 Cir. 1950), 179 F. 2d 863, 38 AFTR 1357; cf. *Morse* v. *Commissioner* (2 Cir. 1953), 202 F. 2d 69, AFTR.

[5] *David Anderson,* 5 T.C. 1317 (1945); *K. R. Kingsbury,* 31 BTA 1126 (1935); *E. T. Sproull* v. *Commissioner* (6 Cir. 1952), 194 F. 2d 541, 41 AFTR 849.

[6] Since 1942, the Code requires the same result as was reached in the cases cited under footnotes 4 and 5. 1954 IRC §§ 403(b), 402(b); 1939 IRC §§ 22(b)2(B), 165(c).

[7] *K. R. Kingsbury,* footnote 5 supra; *Morse* v. *Commissioner,* footnote 4 supra.

[8] 1954 IRC § 404(a)5; 1939 IRC § 23(p)(1)(D).

[9] Reg. 118 § 39.23(p)-11.

[10] Reg. 118 § 39.42-2.

[11] 8 T.C. 809 (1947) Acq. involving the tax year 1941, and par. 49,253 Prentice-Hall Memorandum T.C. (1949) involving the year 1942; cf. *Joseph Frank,* 22 T.C. 113 (1954).

The taxpayer, prior to November 1, 1940, was entitled to a bonus for 1940 based on a percentage of 1940 sales. By an agreement dated November 1, 1940, the bonus for 1940 was to be payable quarterly in 1942 instead of in 1941. Under date of December 26, 1941, the taxpayer and his employer entered into an agreement providing that the bonus for 1940 should be payable in five equal installments in the years 1942 to 1946 inclusive, instead of all in the year 1942. The agreement also extended the period of employment. The history of this bonus arrangement was that the employer had always been late in making the bonus payments and the Court found as a fact that the deferment arrangement was mutually profitable. The taxpayer already had a large income for 1941 and moved to a community property state in that year, so that the deferment was obviously to his advantage. The first case related to the year 1941 in which the Commissioner determined the 1940 bonus was constructively received. The Court held that it was an arm's-length business transaction and not a sham, and the bonus was not constructively received. The contract of November 1, 1940, was made at a time when the bonus was not fully earned and the amount was not known. The second case involved an effort by the Commissioner to tax the 1940 bonus as constructively received in 1942. At the time of the December, 1941, agreement, the 1940 bonus had been fully earned and the amount of it was known. The Court held that this latter agreement was also a bona fide mutually advantageous agreement and there was no constructive receipt because at no time in the year 1942 was the bonus subject to the taxpayer's withdrawal.

The position of the Tax Court was again set forth in the case of *Commissioner* v. *Oates*.[12] Oates, a general agent for Northwestern Mutual Life, was entitled to renewal commissions for the first ten years on policies written by him or his agency. Just before retirement, Oates took stock on what he could expect in renewal commissions after he ceased to work. In the first year, he could expect high income since commissions would be paid on policies written during the nine years previous to retirement. Thereafter, they would drop until, in the ninth year of retirement, he would receive commissions on policies written in a single year. Commissions also would be reduced in the later years because of a greater percentage of policies that would lapse as those insured failed to renew.

Four days before he retired, Oates signed a contract with Northwestern calling for $1,000 a month for 15 years, in lieu of the normal method of paying renewal commissions. The monthly installments were based on estimated renewal commissions. Adjustment for the amount of renewal commissions in excess of the total of the monthly payments was to be made by a lump sum payment at the end of 15 years. In the first full year of retirement, renewal commissions were $42,375 and thereafter they dropped until in the seventh year they totaled only $13,000. Oates had guessed right. He would have had heavy income and a heavy tax in the early years on renewal commissions, but a rapid decline in income in the later years. The Bureau claimed Oates had to pay a tax on the full amount of accrued commissions each year even though he was paid only $12,000 a year. The Tax Court allowed Oates to spread income and his tax. Prior to the time renewal commissions were due, he entered into a binding contract covering method of payment. He was only entitled to the amounts actually paid him.

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[12] (7 Cir. 1953) 207 F. 2d 711. Non-Acq.

His tax is measured by the actual payments. The Government appealed to the Court of Appeals for the Seventh Circuit, and the Court of Appeals affirmed the Tax Court.

Another interesting case is that of *Wilfred Weathers.*[13] Weathers had a hop farm and in January of 1944 entered into a written contract for the sale of his 1944 crop. Prior to February 12, 1944, an oral agreement was made between the parties that no cash would be paid Weathers for his crop until January, 1945. The crop was harvested and delivered in September and October, 1944. Weathers was successful in having the cash received in January of 1945 taxed as 1945 income and there was no constructive receipt when the hops were delivered.

Although these cases appear to establish that deferred compensation is not taxable until it is payable under the terms of the contract, the law in this field cannot be regarded as settled at present. The Internal Revenue Service has naturally been reluctant to allow taxpayers to have income earned in years in which they are in very high tax brackets deferred to some later year. Such contracts both postpone the time when the taxes are collected and result in a lower tax being paid on the compensation when received. It is important to note that the Service has issued its non-acquiescence to the *Oates* decision and has expressed no opinion on the second *Viet* case or the *Weathers* case but, as a matter of policy, the Service does not state its position with regard to memo decisions. In view of this situation, it appears desirable to provide additional precautions if they are feasible in the particular case.

5. Provisions Which Will Strengthen the Case for Deferment of Income Tax

If there are any substantial conditions attached to the deferred payments, these should certainly defeat any effort by the Service to tax the payments as constructively received. Some of the more usual provisions are that the employment continue for a particular period of years or until a certain age is reached; that the employee be available as a consultant; that he agree not to compete or enter the employ of a competitor; that he shall not earn more than a certain amount during the period when the deferred compensation is payable or that the income earned be used to reduce the employer's payments; future payments to vary with living costs, employer profits, etc.

The conditions used in any contract should be realistic as applied to the facts of that particular situation. For example, do not use an agreement not to compete after retirement, if the only way in which the retired executive could compete would be by getting a job with a large competitor and these competitors themselves have retirement plans and would not be interested in hiring anyone over 65 years old. The use of a condition which obviously has no practical application and is inserted solely for tax purposes would be worse than not having such a condition in the contract.

Although it should not make any difference legally, the courts have cited in favor of the employee the fact that the deferred payment date was requested by the employer.[14] Also, it should not make any difference whether the contract is assignable or not, but the courts have cited the fact that the contract was non-assignable in form, in holding that there was no receipt of income.[15] In a close case, it would be helpful to have these factors in the employee's favor.

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[13] Par. 53, Prentice-Hall Memorandum T.C. (1953). Cf. *Kasper* v. *Banek* (8 Cir. 1954), 214 F. 2d 125; *Malmberg* v. *Lamb* (D.C. N.D. 1953); *Hineman* v. *Broderick* (D.C. Kans. 1951), 99 F. Supp. 582, 41 AFTR 582.

Payments of income for life by the employer are in a particularly favored class. The courts have held in a long line of cases that, when assets are sold in exchange for an annuity for life, payable by a corporation not in the business of writing commercial annuities, the annuity has no fair market value, and no income is realized on the transaction.[16] The Commissioner has acquiesced in this line of cases which would seem to leave them as unquestioned statements of the law. If such annuities are not treated as income to the extent that they exceed cost basis, when received in exchange for property, they should certainly not be treated as income when received for services.

Furthermore, pensions may receive more favorable treatment than other types of deferred income, because the employers are more frequently paying pensions, and contracting for the payment of a pension is not substantially different in effect from what many employees expect to receive as a matter of company policy instead of contract.

Also, the courts have had occasion to pass on a few contracts involving pensions which had vested and without exception held that no income was realized on the vesting of the pension for life.[17] It is interesting that in these cases the Commissioner was upheld in his contention that the employee realized no income on the vesting of the pension. Therefore, it is to be expected that the Commissioner would make no effort to tax currently the compensation deferred into a pension.

The unusual provision in the Code[18] granting capital gains treatment on the release by an employee, after more than 20 years' employment, etc., of benefits which were to begin after termination of employment, is further evidence that such benefits were not taxable income when the services were performed.

Where the taxpayer is the principal executive officer of the employer or he and his family control the employer through stock ownership, special precautions must be taken. There is a substantially greater danger of constructive receipt because of the taxpayer's control over the employer's actions.[19]

6. Specific Types of Deferred Compensation Plans

There are almost infinite varieties of deferred compensation plans in existence. A review of some of the plans which are matters of public record or have been reported upon will be helpful in selecting the plan most appropriate to a particular situation. Contracts in the entertainment field have received the most publicity. The National Broadcasting Company contract with Milton Berle is reported to pay him $50,000 a year for 30 years. For the first 10 years, Berle is required to perform in diminishing amounts. For the second 10 years, he is not required to perform, but is obligated to serve as a producer, writer or consultant, etc. For the third 10 years, he has no obligations or duties of any sort.[20] Walter Winchell is reported to have a contract with his sponsor, the Hudnut Company, under which he receives $9,000 a week in cash plus an option to buy 10,000 shares of Hudnut stock at current quotations. Also, his network, ABC, pays him $50,000 a year as consultant on a lifetime contract, and he is scheduled to receive an option on the network stock.

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[14] *Howard Veit, supra,* footnote 6 in the case involving the year 1942.

[15] *Frederick John Wolfe,* 8 T.C. 689 (1947) at page 701.

[16] *J. Darsie Lloyd,* 33 B.T.A. 903 (1936) Acq.; *Frank Deering,* 40 B.T.A. 985 (1939) Acq.; *Bella Hommel,* 7 T.C. 992 (1946) Acq.; *Bertha F. Kann* v. *Commissioner* (3 Cir. 1949), 174 Fed. 865, 29 AFTR 1189.

[17] *Hooker* v. *Hoey* (D.C. S.D. N.Y. 1939), 27 F. Supp. 489, 23 AFTR 458, aff'd (2 Cir. 1939) 107 F. 2d 1016, 23 AFTR 936; *Frederick J. Wolfe, supra,* footnote 15; *William E. Freeman,* 4 T.C. 582 (1945).

[18] 1954 IRC § 1240; 1939 IRC § 117(p).

[19] *Richard R. Deupree,* 1 T.C. 113 (1942); *J. H. McEwen,* 6 T.C. 1018 (1946).

Some of our leading corporations, such as General Motors and du Pont[21] have a deferred bonus system under which payments are made four or five years after the bonus is earned. Such payments may be in stock of the employer or in cash, or in a combination of the two. Several types of contracts used by leading corporations to provide retirement pay for their executives are set forth in the study by William J. Casey and J. K. Lasser, entitled "Executive Pay Plans." [22]

The contract involved in the *Oates* case[23] is an example of the manner in which the general agent of an insurance company may defer the receipt of renewal commissions. Contracts have been made in the investment banking business for the compensation for underwriting of a particular security issue to be spread over a number of years, such as 10 or 15 years.

It is reported that George Hammer conceived and, more than any one individual, put over the sale of the Empire State Building. On this $50,000,000 deal, Hammer will receive about $500,000 in commissions, which are to be paid at the rate of $50,000 a year for 10 years. Hammer and his firm also received a 10-year management contract providing for a fee of $50,000 a year.

As a general rule, where the probability is that the services will continue to be rendered until retirement, the deferred portion of the compensation will usually begin at retirement. However, where the services are all performed in a short period of time or their duration is very uncertain, payments will usually begin immediately and will be spread over a term of years or for life.

7. Conclusion

There are definite advantages in the use of deferred compensation contracts or arrangements where the employee or independent contractor is in extremely high tax brackets and the employer is financially sound enough so that there is no real doubt about the employer's ability to pay when the due dates arrive. On the basis of the present case law, such deferred compensation should not be taxable to the employee on the cash basis until it is received. However, at the present time, the Internal Revenue Service has refused to accept these decisions, and it is therefore desirable at present to include real contingencies in the contracts as additional protection against being currently taxed on the income. This additional protection would appear unnecessary where the deferred payments are pensions beginning at a normal retirement age, payable solely from the general funds of the employer. Deferred compensation contracts are also appropriate to a single transaction, such as a real estate broker selling an office building or a farmer selling his crop. However, it is essential that the deferred payment contract be entered into before the right to receive payment becomes fixed.

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[20] See William J. Casey and J. K. Lasser, *Executive Pay Plans* (1951), page 35.
[21] Casey and Lasser, *ibid.*, pages 31 to 33.
[22] *Op. cit.*, pages 39 to 44.
[23] Footnote 12, above.

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26

Travel and Entertainment Expenses

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There have been few problems which have plagued the taxpayer, the courts and the Treasury Department quite as much as the right to deduct travel and entertainment expenditures for Federal tax purposes. The problems arise not so much from complicated Code provisions or Regulations which are difficult to interpret, although problems do arise as to the meaning in context of commonplace words, but rather from the attempts to merge on a workable, if not a logical, basis the divergent views of the businessman and the tax collectors on what amounts are essential expenditures to business. The problems are similar with respect to the deduction of such expenses which are not business expenses, but are incurred for the collection or production of income, or for the management, conservation or maintenance of property held for the production of income.

A businessman feels natural resentment that his judgment should be questioned in determining what expenditures are necessary to his particular business. He knows that there are many ways to run a railroad, and that he is the best judge of how to run his railroad. Business is competitive, and if the businessman feels it is advisable, although perhaps not absolutely necessary, to entertain lavishly a potential customer whom he has known for some time casually on the speculative chance he might acquire a new customer, he feels it is good business so to do. Of course, in such a case, to strike the right note, good competitive business practice indicates that the potential customer should bring his wife along, and so the businessman's wife is essential to the party. With a minimum of investigation, the businessman learns that the potential customer is fond of Beef Stroganoff and has an obsession for good musical comedies. Since the businessman was planning anyway to take his wife out for dinner and to a show, he kills two birds with one stone and invites the potential customer in the hope, real but remote, that he will acquire a customer.

The tax collector looks upon this party through polaroid glasses, and he obtains a different view of it. The chance of acquiring a customer may exist, but it is too remote to allow wives along and to justify the amount spent. Further, the tax collector has heard so often that no customers are ever obtained on the golf course, and it seems to him that a smoke-filled night club or a darkened music hall is less conducive to obtaining business than the relaxed atmosphere of the golf links. And if he is something of a philosopher, he might muse as to why Uncle Sam should bear a major portion of the cost of this party which after all provides pure entertainment of a personal nature for all concerned.

Or, again, take the man whose business without any question requires him to be in Florida at some time for a day or two. The businessman elects March 1 as the proper date. To reach Florida, the man takes his yacht, clears up his business, remains in Florida for three weeks and then takes his yacht back to New York, returning to work the next day. The travel expenses might seem excessive to an examining agent, and he might even suggest that the businessman deliberately arranged his meeting in Florida on March 1 so that Uncle Sam could share in the cost of a holiday. The examining agent, in justification of the substitution of his judgment for the businessman's as to proper business expenses, might even suggest that the business would have been better served had the man gone to Florida out of season on the day before Christmas. The businessman indignantly cries that he can arrange his business affairs as he sees fit. The examiner in an equally loud voice shouts that Uncle Sam cannot be made to pick up the check for yachting excursions, vacations and frolics.

Other problems arise. A businessman with a home in Connecticut has a flourishing business in New York. He also has a home in Florida. Some time after he acquires the home in Florida, he goes into the real estate business on a very limited scale in Florida or acquires a small orange grove. Thereafter, he deducts his expenses of traveling to and from Florida and many of the expenses of his Florida residence as travel expenses while away from home in connection with his real estate business or the orange grove.

1. Points to Consider

To chart the tortuous course through such problems and to ascertain what are deductible travel and entertainment expenses and how they should be handled, it is necessary to consider, among other things:

	Section
The Code and Regulations	2(a), (b), (c)
What expenses are deductible in computing "adjusted gross income"	2(c), 3(b)
The nature of the expenses, that is, whether they are "ordinary and necessary" and whether reasonable in amount, if that is a test	3(a)
Whether travel expenses are incurred away from home	3(b)
Whether the expenses are personal	3(c), 4(a)
How are such expenses handled by employees	4(b)
How are accountable and non-accountable expense allowances of employees handled	4(c), (d)
What accounting for such expenses is necessary	4(d)
What the current and possible future Treasury Department practices are with respect to such expenses	4(d), 5

2. The Mechanics of Deduction Under the Code and Regulations

a. Business expenses. Travel and entertainment expenses are deductible in computing taxable income under 1954 IRC § 162(a) (derived from 1939 IRC

§ 23(a)(1)) if connected with a trade or business of the taxpayer. This section provides for the deduction of:

> all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . (2) traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business;

Regulations 118, Section 39.23(a)-1, relating to business expenses, provides that among the deductible items are:

> . . . travel expenses while away from home solely in the pursuit of a trade or business[1]. . . .

What is meant by travel expenses away from home in connection with a trade or business is described in Regulations 118, Section 39.23(a)-2.

b. Expenses not connected with business. Travel and entertainment expenses, if not connected with a business, are deductible under 1954 IRC § 212 (derived from 1939 IRC § 23(a)(2)), as follows:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
> (1) for the production or collection of income;
> (2) for the management, conservation, or maintenance of property held for the production of income; or
> (3) in connection with the determination, collection, or refund of any tax.[1a]

This section applies only to individuals, estates and trusts. Regulations 118, Section 39.23(a)-15, covering deductions of non-trade or non-business expenses, does not provide specifically for the deduction of travel or entertainment expenses, but it is clear that those kinds of expenses are deductible if made for one of the purposes named in 1954 IRC § 212.[2]

Similarly, if the purpose of taking a trip is to provide "medical care," the actual transportation expense is deductible as a medical expense under 1954 IRC § 213:

> (e) Definitions—for purposes of this section—
> (1) The term "medical care" means amounts paid—
> (A) for the diagnosis, cure mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body (including amounts paid for accident or health insurance), or
> (B) for transportation primarily for and essential to medical care referred to in subparagraph (A).

It would seem to be a minimum precaution to have a doctor's order, or very strong recommendation for such a trip in order to substantiate the purpose and the "essential" nature of the trip. Such a deduction has been permitted also under 1939 IRC § 23(x), even though there was no express statutory mention of such transportation expense.[3]

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[1] References to provisions of the Treasury Regulations are to those promulgated under the 1939 Code, as amended; since most of the 1939 Code sections applicable to the Article have been enacted substantially in the same form, the present Treasury Regulations are not inconsistent and, therefore, still pertinent (Rev. Rul. T.D. 6091; 19 Fed. Reg. 5167, Aug. 17, 1954); probably they will undergo little, if any, change when promulgated pursuant to the provisions of the 1954 Code. See *Basse*, 10 T.C. 328 (1948) for effect of word "solely." Cf. *Gaines, Inc.*, par. 51,105 Prentice-Hall Memorandum T.C. (1951).

[1a] The inclusion of subparagraph (3) changes the law and allows the deduction of expenses incurred in connection with gift tax liability.

[2] *Louis H. Mayer*, par. 51,175 Prentice-Hall Memorandum T.C. (1951); *Vincent Treanor*, par. 51,100 Prentice-Hall Memorandum T.C. (1951); *Coffey*, 1 T.C. 579, *aff'd without discussion of this point* (5 Cir. 1944), 141 F. 2d 204, 32 AFTR 276.

The House Committee Report, p. A60, for 1954 IRC § 213 states:

> The deduction permitted for "transportation primarily for and essential to medical care" clarified existing law in that it specifically excludes deduction of any meals and lodging while away from home receiving medical treatment. For example, if a doctor prescribes that a patient must go to Florida in order to alleviate specific chronic ailments and to escape unfavorable climatic conditions which have proven injurious to the health of the taxpayer, and the travel is prescribed for reasons other than the general improvement of a patient's health, the cost of the patient's transportation to Florida would be deductible, but not his living expenses while there. However, if a doctor prescribed an appendectomy and the taxpayer chose to go to Florida for the operation, not even his transportation costs would be deductible. The subsection is not intended otherwise to change the existing definitions of medical care, to deny the cost of ordinary ambulance transportation nor to deny the cost of food or lodging provided as part of a hospital bill.

The Commissioner's main reliance to limit non-business deductions is 1954 IRC § 262 (substantially unchanged from 1939 IRC § 24(a)(1)):

> Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

c. Deduction of expenses in computing adjusted gross income. Section 62 of 1954 IRC (derived from 1939 IRC § 22(n)), provides that in computing "adjusted gross income," the following amounts are to be deducted from gross income:

> (1) Trade and Business Deductions.— . . . if such trade or business does not consist of the performance of services by the taxpayer as an employee.
>
> (2) Trade and Business Deductions of Employees.—
>
> (A) Reimbursed Expenses.— . . . in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer.
>
> (B) . . . expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee.
>
> (C) . . . expenses of transportation paid or incurred by the taxpayer in connection with the performance by him of services as an employee.
>
> (D) Outside Salesmen.—The deductions . . . attributable to a trade or business [as an employee] away from the employer's place of business [soliciting] business for the employer.

Taxpayers who have expenses deductible under this section have the advantage of being able to deduct them in computing "adjusted gross income" and may thereafter compute their tax using either the short form tax table or the standard deduction on Form 1040.

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[3] *Stringham,* 12 T.C. 580, aff'd 183 F. 2d 579, 39 AFTR 777 (6 Cir. 1950); *Duff,* par. 53,362 Prentice-Hall Memorandum T.C. (1953); *Watkins,* par. 54,102 Prentice-Hall Memorandum T.C. (1954); *Hollander,* 22 T.C. #84 (1954). These decisions are in harmony with Reg. 118, § 39.23(x)-1, allowing deduction of "expenses for . . . travel primarily for and essential to the rendition of the medical services or to the prevention or alleviation of a physical or mental defect or illness. . . ."

3. Travel Expenses

In *Commissioner* v. *Flowers*,[4] the Supreme Court in substance set up three conditions which must be satisfied to justify the deduction of travel expenses as business expenses under 1939 IRC § 23(a)(1), now substantially the same in 1954 IRC § 162. These conditions were stated to be:

> 1. The expense must be a reasonable and necessary traveling expense, . . .
> 2. The expense must be incurred "while away from home."
> 3. The expense must be incurred in pursuit of business. This means that there must be a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer or his employer. Moreover, such an expenditure must be necessary or appropriate to the development and pursuit of the business or trade.

While these conditions may overlap and perhaps are vague and difficult to ascertain in a given case, failure to satisfy any one of the conditions will generally result in disallowance of the deduction. Undoubtedly, the same general tests would apply with respect to the deduction of travel expenses under 1954 IRC § 212, except that expenses there would, of necessity, have to be paid or incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax, rather than "in pursuit of business."[5]

a. The equivocal nature of reasonableness of amount. That the travel expense must be "reasonable" in amount is not an express requirement of 1954 IRC § 162, or its predecessor, 1939 IRC § 23(a)(1), although it has been a requirement of the Regulations, § 39.23(a)-2, for so long that it may have assumed statutory importance. The statute provides only that the expense be "ordinary and necessary." Despite the provision of the Regulations, for many years the practical test of ordinary and necessary, except in special situations, has not included a separate test of reasonableness beyond the assumption that an expense was reasonable if ordinary and necessary. This continued to be true even after the *Flowers* case. Generally, any separate test of reasonableness, applied to impose objective standards as to the permissible size of expenses which in nature were admittedly for business purposes, has been limited to deductions for depreciation and compensation for services rendered, for which the statute expressly provides this requirement, and to those for amortization, for which the statute makes detailed provision as to computation.

If the seemingly additional test of reasonableness of amount is but a matter of semantics, and if expenses, other than compensation for services, depreciation and amortization, are assumed to be reasonable in amount as long as paid or incurred for business purposes, the pattern of the past cases will be maintained. But if the test of reasonableness of amount is to be applied using objective standards, as is done in the case of compensation, to determine whether travel expenses or other such expenses are too lavish *per se*, too expensive in comparison with the expected return to be derived, or excessive when compared to the expenditures of businesses similarly situated, the results of the cases which have been used as precedents for many years must be re-examined.

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[4] 326 U.S. 465 (1946), 34 AFTR 301.

[5] Travel expenses, which otherwise might be deductible under 1954 IRC § 212; 1939 IRC § 23(a)(2), may be part of the cost basis of acquiring or defending title to a capital asset. Reg. 118, § 39.23(a)-15(k).

There are evidences that the test of reasonableness, superimposed upon or inherent in the test of ordinary and necessary, may already be or may become a factor. In *The Lincoln Electric Company* v. *Commissioner*,[6] the Circuit Court of Appeals, in remanding the case to the Tax Court, suggested that certain incentive payments, which were not deductible by the company as compensation under 1939 IRC § 23(a)(1) wherein the test of reasonableness is contained with respect to compensation deductions only, were deductible if ordinary and necessary without inquiry into their reasonableness. The case eventually came before that Court again[7] which "clarified" its prior decision by stating that in effect the test of "ordinary and necessary" inherently includes the element of reasonableness. The Court said:

> The deduction authorized by our prior ruling was plainly based on the broader ground of ordinary and necessary expenses, which would include items not of a compensatory nature, such as rent, advertising, transportation and communication charges, repairs and other such operating charges. Such payments are made proper deductions by the statute, but with respect to them there is no express statutory provision limiting them to a reasonable amount, as is the case in payments of compensation for personal services. However, the element of reasonableness is inherent in the phrase "ordinary and necessary." Clearly it was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount.

The Court went on to state that the *Flowers* case approved the use of the term "reasonable" in the Regulations with respect to travel expenses despite the fact that the word was used in 1939 IRC § 23(a)(1) only in connection with compensation.

There is other evidence that the test of reasonableness of amount, separate and distinct from ordinary and necessary, is to be applied. On February 26, 1952 the Treasury issued a press release[8] stating that the deduction of lavish travel and entertainment expenses, among other items, would be subject to closer scrutiny to ascertain whether they are "excessive and unreasonable."

If the test of "reasonableness" of amount is to be applied by use of objective standards, to travel, entertainment and other expense deductions, even though admittedly the expenses are in the pursuit of legitimate business, are not a cloak for the deduction of personal expenses and are not a disguise for a dividend or a gift, the situation, as a practical matter, could become difficult. For example, must you travel by rail instead of plane, assuming you have time, because it is cheaper? If you are going by train, must you ride the coach, or may you legitimately be comfortable in a pullman? Merely to state such questions is to indicate the impracticality of establishing objective standards of reasonableness of amount. As applied to entertainment expenses, if you are entertaining a customer, must you consider whether he will bring you enough business to justify the Stork Club, or is he an automat customer? Opinions differ as to how to get business and who may be a good customer. Is it reasonable to entertain a customer's wife when you entertain a customer, and may you bring your wife along? What are the standards to be applied to offer a guide?

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[6] (6 Cir. 1947) 162 F. 2d 379, 35 AFTR 1470, reversing 6 T.C. 37 (1946).

[7] (6 Cir. 1949) 176 F. 2d 815, 38 AFTR 411, and cases cited; on remand, 17 T.C. 1600 (1952).

[8] Treasury Department Press Release § 2979, February 26, 1952.

Other questions which perhaps differ in concept but which are related may be asked. Suppose a corporate executive making a business trip in a company plane invites his wife to occupy an empty seat. Should a part of the cost of the flight, including depreciation on the plane, be attributed to the use by the wife? To fly this airplane to the point of no return, it could be argued that the company, in allowing the wife to fly, was in effect paying the official additional compensation, and while there would be no disallowance to the company under this theory, the official would have additional income without an offsetting deduction. Or it might be argued that part of the cost should be disallowed to the company as a business expense unreasonable in amount. Or if logic is irresistible, part of the cost might be disallowed, and the value of the wife's use, which inevitably would be less than the cost so disallowed, taxed as compensation to the husband with a deduction of that amount to the company as compensation paid. Or again, suppose an individual entertains a customer at a rather lavish dinner. While it could possibly be argued that the portion of the check equivalent to the taxpayer's ordinary cost of dinner should not be allowed, will it now also be seriously argued that the balance of the check for himself is not attributable to the pursuit of business or is an expense unreasonable in amount? If such contentions are made for disallowance, they are best rationalized not by a test of "reasonableness," but rather by the concept of "ordinary and necessary"—which has the advantage, among others, of involving less invidious personal reflections than does the former—or by the theory that expenses not connected with trade or business (i.e., personal) should be disallowed.

The questions posed are not academic, having been raised at one time or another. It is suggested, and it is hoped that the courts will agree, that the question of reasonableness and extent of the ordinary and necessary test should be judged without refined theoretical preciseness to achieve a generally fair result consistent with business practices and the prevention of undue tax avoidance. The taxpayer, on the other hand, might be well advised to exercise moderation with respect to the business amounts involved in claiming deductions, and to avoid extreme claims which invite the formulation of refined and troublesome distinctions.[9]

b. One's home and when one is away. In the *Flowers* case, the court placed emphasis upon the requirement that an employee's traveling expense shall have been incurred in pursuit of the business of the employer, but it also emphasized the requirement that an expense must be incurred "while away from home" to be deductible. This test has given rise to an enduring controversy.

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[9] The courts tend not to concern themselves with "nice" questions of theory in connection with expenditures which are patently moderate. *Penn* v. *Robertson* (4 Cir. 1940), 115 F. 2d 167, 25 AFTR 940. *Rogers Dairy Co.*, 14 T.C. 66 (1950); *McLennan*, par. 45,217 Prentice-Hall Memorandum T.C. (1945); *Mahoney*, par. 45,122 Prentice-Hall Memorandum (1945). Cf. *Dr. Sutter*, 21 T.C. 170 (1953).

An individual taxpayer will contend that travel expenses should be deductible if incurred while away from "home," meaning a permanent abode to which he looks to return. On the other hand, the Treasury Department has contended, with increasing success, that "home" means the taxpayer's regular place of duty.[10]

In Revenue Ruling 54-147 (1954 I.R.B. 17) on the expenses of professional baseball players and other baseball personnel, the Service stated:

> It is the well-established position of the Internal Revenue Service that the term "home" as used in section 23(a)(1)(A) of the Code means the taxpayer's principal place of business, post of duty, or place of employment. . . . [W]here baseball players, managers, coaches or trainers also engage in another trade or business during the taxable year a factual determination must be made as to the situs of the taxpayer's principal business post, i.e., his tax "home."
>
> The more important factors to be considered in making [the determination] . . . are the total time ordinarily spent by the taxpayer at each of his business posts, the degree of business activity at each such post, and whether the financial return in respect of each post is significant or insignificant.

The attempts to decide when a person is away from home have resulted in a series of decisions which cannot be reconciled. Problems arise in connection with an employee whose job is away from his home and the businessman with multiple business locations or multiple residences.

In an attempt to resolve these problems, the courts have made a distinction between "temporary employment," on the one hand, and "indefinite" or "indeterminate" employment, on the other. Expenses relating to the first have been held deductible because the taxpayer is away from "home" only temporarily.[11] Expenses of the second have been held not to be deductible either because the employee is not away from "home," home being where he intends to be indefinitely, or because the employee, in maintaining a home away from his indefinite employment, is doing so for his own convenience.[12]

In one case, the court resolved the question very neatly by disallowing a construction worker a deduction for travel expenses on the theory that expenses were personal "when they stem from the petitioner's refusal to bring his home close to his job." [13] The court, in another case, took the concept one step further by analyzing when "temporary" employment became "indeterminate." [14] The situation where a person is employed where his family cannot go has confused the concepts; if a man cannot take his family on a job, by all reasonable standards his employment should be considered temporary; yet, conflicting results have been reached.[15]

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[10] *Commissioner* v. *Flowers*, footnote 4, above; *Hammond* v. *Commissioner* (5 Cir. 1954), 213 F. 2d 43, affirming 20 T.C. 34; *Carragan* v. *Commissioner* (2 Cir. 1952), 197 F. 2d 246, 41 AFTR 1394; *Johnson*, 17 T.C. 1261 (1952); *Harry F. Schurer*, 3 T.C. 544 (1944); *Charles Gustafson*, 3 T.C. 998 (1944). But see *John Wallace Winborne*, par. 44,207 Prentice-Hall Memorandum (1944), affirmed *Barnhill* v. *Commissioner* (4 Cir. 1945), 148 F. 2d 913, 33 AFTR 1203; *Wallace* v. *Commissioner* (9 Cir. 1944), 144 F. 2d 407, 32 AFTR 1209.

[11] *E. G. Leach*, 12 T.C. 20 (1949); *Harry F. Schurer*, footnote 10, above.

[12] *Hammond* v. *Commissioner*, footnote 10, above, denied deduction for travel from the taxpayer's abode in New Orleans to his job in Baton Rouge even though taxpayer's wife was employed in New Orleans which he claimed as "home"; *W. H. Harrington*, par. 53,139 Prentice-Hall Memorandum (1953); *Albert*, 13 T.C. 129 (1949), 15 T.C. 350 (1950); *Giffels, et al.*, par. 49,257 Prentice-Hall Memorandum (1949).

[13] *Carragan* v. *Commissioner*, footnote 10, above. Followed in *Hammond* v. *Commissioner*, footnotes 10 and 12, above.

[14] *Arnold P. Bark*, 6 T.C. 851 (1946).

If an individual has one place of business, the area of doubt is usually small, and it seems needless to make metaphysical distinctions. If the individual maintains a home away from his job or his place of business, it is generally for his own convenience and his expenses in traveling between his home and his job and living expenses to maintain him at his job or place of business are personal and not deductible.[16] Such expenses are in the nature of commuter expenses which have long been held non-deductible even in most unusual cases.[17]

On the other hand, if an individual maintains a regular place of business and he travels on business away from that regular place, he should, and undoubtedly will on one theory or another, be considered as in travel status. If he maintains multiple places of business, or is in a position where it is difficult to determine where he maintains his home or his regular place of business, trouble may develop. Thus, in *Vincent Treanor*,[18] where taxpayer maintained two business locations, it was made clear that the expenses of reaching and maintaining himself at one of these locations were deductible as travel expenses.

Another problem is encountered with respect to transportation expenses incurred by an employee on short daily, non-commuting trips after which the employee returns to spend the night at home. Car expenses or public transportation fares on such trips would be deductible as trade or business expenses under 1954 IRC § 162 (and under 1939 IRC § 23(a)(1)); but the deduction of trade or business expenses in computing adjusted gross income was not permitted for employees under 1939 IRC § 22(n)(1), and the Treasury Department insisted that an employee, if he was not reimbursed by the employer, be away from home at least overnight before it would allow such expenses as "travel expenses" under

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[15] Cf. A. *Gilbert Formel*, par. 50,221 Prentice-Hall Memorandum (1950) and I.T. 1355 (1922)-1 C.B. 194, with *Chester D. Griesemer*, 10 B.T.A. 386 (1928) for comparable factual situation with different results; cases present question of deduction of expenses attributable to a job to which family cannot go, and thus raise the question of whether employee is in travel status which in turn raises question of temporary as against indeterminate employment.

[16] *Commissioner* v. *Flowers*, footnote 4, above; Leon Falk, Jr., 15 T.C. 49 (1950), *affirmed without discussion of this issue* (3 Cir. 1951), 189 F. 2d 806, 40 AFTR 783; *John Chapman*, 9 T.C. 619 (1947); *John D. Johnson*, 8 T.C. 303 (1947); *O'Hara*, 6 T.C. 841 (1946); SM 1048, 1919 C.B. 101.

[17] *Wilbur H. Clayton*, par. 48,104 Prentice-Hall Memorandum (1948); *Mullins*, par. 47,106 Prentice-Hall Memorandum (1947); *John S. Martin*, par. 44,198 Prentice-Hall Memorandum (1944); *Schmidt*, 11 B.T.A. 1199 (1928). In *John C. Bruton*, 9 T.C. 882 (1947) and *Esther E. Ranstead*, par. 51,033 Prentice-Hall Memorandum (1951), it was argued that for an invalid taxpayer, the entire expense of going to and from work in a taxi was an ordinary and necessary expense to maintain his employment since he could not reach his place of employment by any other means; the court denied the deduction on the grounds that the expenses were personal, being commuter expenses. See, however, *Misfeldt* v. *Kelm* (N.D. Minn. 1951), 52-2 U.S.T.C. § 9495 for the possibility of deducting such taxi fares as medical expenses under IRC § 23(x). The suggestion by the Tax Court in *Dr. Sutter's* case (footnote 9, above) that a given expense may be analyzed into two components, one part personal and one part business, would seem to give some hope that the portion of a commutation expense attributable solely to an abnormal medical condition would be deductible as a medical expense if the casual relation could be proved. Deduction for travel expense within the greater Boston area was disallowed to a suburbanite taxpayer since he was "near enough to his home so that he could return there from Boston without extensive travel"; *Amoroso* v. *Commissioner* (1 Cir. 1952), 193 F. 2d 583, 41 AFTR 616, *cert. den.*, 343 U.S. 926, and cases cited therein.

[18] Footnote 2, above.

§ 22(n)(2). This problem has now been met by the express grant of a deduction in 1954 IRC § 62(2)(C) of an employee's transportation expenses "paid or incurred by the taxpayer in connection with the performance by him of services as an employee." Thus, while such travel expenses as meals and lodging are only deductible if "away from home," "transportation expense" is no longer tied to that requirement in order to be deductible in computing adjusted gross income.

c. Incurred in pursuit of trade or business. As a practical matter, many of the problems discussed above can be resolved if a conscientious attempt is made to determine whether the travel expenses are really business expenses, and it is probably fair to say that the various tests and distinctions are merely refinements of the pursuit of business test.

Thus, while a deduction cannot be made for car expenses attributable to commuting between a taxpayer's home and place of business, a deduction of car expenses attributable to business use is allowable. If, however, the car is used *only* for business, other than commuting, the entire expenses would very likely be deductible because the non-business use would be so minor.[19]

If an individual maintains his only place of business in one city and his family home in another, the expenses of living where his business is located are not "ordinary and necessary" business expenses; they are personal expenses, and the only difference between them and commuter expenses is that the claimed business expenses would in this case involve more for transportation and would include meals and hotel rooms.

4. Entertainment Expenses

The considerations for the allowance of entertainment expenses as deductions are essentially the same as for travel expenses except that there are not so many fine distinctions to be made.

a. Must be to aid business. It is usually stated that entertainment expenses to be deductible must be incurred to drum up or expedite business and must be reasonably calculated to accomplish the end sought. If the expenses do not meet this test, they would normally be considered personal expenses. The difficulty with the test is that opinions may justifiably differ as to what is reasonably calculated to drum up or expedite business. The discussion above concerning the test of reasonableness of amount, if applicable at all, would apply equally to entertainment expenses, and thus, there may be an additional requirement which will be difficult, if not impossible, to apply in practice.

The number of cases with respect to the deduction of entertainment expenses is so great it would be impossible to review them, so a few of the more common troublesome points only will be covered. Deductions are warranted if amounts are expended to entertain customers or prospective customers, but one must be careful not to become too close to a customer or the Treasury Department may contend, as it did unsuccessfully in the *Estate of E. R. Fisher*,[20] that a customer had become a friend, and thus as a friend he could not be entertained on the expense account. Deductions are allowed for entertaining persons from whom a business may buy, persons who may aid a business, such as freight agents, and persons who may supply legitimate business information in a legitimate manner, such as choice store locations.[21]

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[19] See *Rodgers Dairy Co.*, footnote 9, above; I.T. 3015, XV-2 C.B. 136 (1936). Records should be kept so taxpayer can prove extent of personal and business use. *Raymond Cassidy*, par. 51,182 Prentice-Hall Memorandum (1951); *Willard Thompson*, 15 T.C. 609 (1950); *John Moore*, par. 50,005 Prentice-Hall Memorandum (1950); *Floyd, Inc.*, par. 43,439 Prentice-Hall Memorandum (1943); Cf. *Leadbetter*, 39 B.T.A. 629 (1939). If an employee's car is driven by other employees for his employer, the employee should be certain to obtain reimbursement for expenses he incurs in connection with this utilization; otherwise deduction may be disallowed on the ground that the expenses are properly the employer's and not the car owner's. See *Diamond*, 19 T.C. 737 (1953).

Entertainment expenses are deductible if incurred at home, but it is well in such cases to have good records of the amount spent, the persons entertained, and their connection with the business.[22]

Expenses may be incurred and deducted in entertainment of employees in building more cordial employer-employee relationships. The amounts spent by an employer in connection with company camps, resorts, golf clubs, swimming pools and parties have been held deductible.[23] Apparently, however, building employee relationships does not extend to wedding gifts given to employees, even though the employee may continue to work.

Club dues have always caused trouble. The deduction is allowed if the club was joined for business reasons and the proof of the business use is clear.[24]

b. Employee expenses and expense accounts. The possibilities of tax savings or increases in "real income" to individual employees through the use of expense accounts or through reimbursement or direct payment of expenses incurred have led Treasury Department officials, especially in the case of closely held businesses, to be rather strict in this area. Excessive expense accounts granted to employees may be viewed as additional compensation taxable to the recipient without an offsetting deduction to the extent that the amount paid by the employer to the employee cannot be substantiated by the employee as having been expended by the employee for business purposes. Although in most such cases the entire amount would normally be deductible to the corporation, if the employee is a stockholder, the excess might be held to be a dividend taxable to the recipient and not deductible by the corporation.

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[20] Par. 52,185 Prentice-Hall Memorandum (1952).

[21] *Rodgers Dairy Co.*, footnote 9, above; *Gaines, Inc.*, footnote 1, above; *McWilliams*, par. 50,234 Prentice-Hall Memorandum (1950); *Limerick*, par. 50,144 Prentice-Hall Memorandum (1950). Entertainment expenses may be allowed even if connected with an illegal business. *Ohio Novelty Co.*, par. 47,293 Prentice-Hall Memorandum (1947) (slot machines); but see *Mill*, 5 T.C. 691 (1945), where expenses of entertaining lodge brothers were disallowed because taxpayer could not prove expenditures increased use of slot machines or directly affected income. This latter type of deduction should not be confused with an expenditure which is itself illegal, and thus in *Lorraine Corp.*, 33 B.T.A. 1158 (1936), a deduction was disallowed for whiskey purchased from a bootlegger in 1926, 1927 and 1928.

[22] *Vinson* v. *United States* (N.D. Okla. 1945), 34 AFTR 1714.

[23] *A. Wolkowitz, et al.*, par. 49,212 Prentice-Hall Memorandum (1949); *Bowman*, 16 B.T.A. 1157 (1929); *Popular Dry Goods Co.*, 6 B.T.A. 78 (1927); I.T. 2529 (1939), IX-1 C.B. 298, revoking OD 1030, 1921-2 C.B. 120. Cf. *A. D. Crews*, par. 52,153 Prentice-Hall Memorandum (1952).

[24] *Johnson* v. *United States* (D.C. Calif. 1941), 45 F. Supp. 377, 29 AFTR 841, *rev'd on other grounds* (9 Cir. 1943), 135 F. 2d 125, 30 AFTR 1393; *Guggenheimer*, 18 T.C. 81 (1952); *Armstrong*, par. 47,245 Prentice-Hall Memorandum (1947); *Louis S. Cohn Co.*, 12 B.T.A. 1281 (1928). See *Mary Sachs*, par. 52,256 Prentice-Hall Memorandum (1952) and *Rose L. Simmons*, par. 50,211 Prentice-Hall Memorandum (1950) and compare *Norman M. Hussey*, par. 52,039 Prentice-Hall Memorandum (1952).

Many executives are paid a flat expense allowance and need not account to the employer. The amount of this allowance should be reported in the gross income of the employee who must justify the deductions to offset the allowance. The use of non-accountable expense allowances without inclusion of the amount thereof in the employee's gross income is not justified; the amount should be included in gross income and the employee should then deduct his legitimate business expenses.

c. Deductibility of non-reimbursed expenditures. In *Hal E. Roach*,[25] the petitioner, on behalf of a corporation of which he was president, spent money for which he was not reimbursed. He claimed the deduction on his individual return. The Board held the expenses were not ordinary and necessary expenses of his earning a salary as president and were not deductible by him even though the expenditures might have been ordinary and necessary expenses of the corporation.[26]

But in *Schmidlapp* v. *Commissioner*,[27] the Court said that the Commissioner was not justified in disallowing deductions for business expenses incurred by a corporate officer on the ground that such expenses were for the corporation's benefit because all of the taxpayer's services were for the benefit of the corporation. The Court went on to say that if the corporation gave the taxpayer to understand that he was to extend hospitality in the corporation's interest, the cost, although non-reimbursed, was a necessary cost of his office.[28]

So it would seem that if a person can establish that non-reimbursed expenditures made by him were made in furtherance of his employer's business with the employer's knowledge and direction, the expenditures would be a proper deduction to the employee.[29] Such a deduction by an employee for entertainment expenses would be permissible in computing taxable income, but not in computing adjusted gross income unless the employee qualified as an "outside salesman." [30]

To aid in establishing the right of an employee to deductions for non-reimbursed expenditures and to meet the requirement that such expenses be incurred with the employer's knowledge and direction, corporations in determining salaries often state that the amount of the salary is fixed with the knowledge that the recipient will be spending an indeterminate amount in furtherance of the business of the corporation. Or again, administrative manuals will contain a provision that certain entertainment expenses which it is expected will be incurred by employees, such as club dues, will not be reimbursed. If an employee has a contract with his employer, the contract may contain a provision that the employee is expected to expend amounts, without reimbursement, in furtherance of the employer's business.

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[25] 20 B.T.A. 919 (1930).

[26] See also *Fred F. Fischer*, par. 47,131 Prentice-Hall Memorandum (1947).

[27] (2 Cir. 1938) 96 F. 2d 680, 21 AFTR 175.

[28] See also *John S. Thompson*, par. 50,199 Prentice-Hall Memorandum (1950); *Abraham*, 9 T.C. 222 (1947). Cf. *Hill* v. *Commissioner* (4 Cir. 1950), 181 F. 2d 906, 39 AFTR 435, *rev'g*, 13 T.C. 291 (1949).

[29] See discussion of *The Lincoln Electric Co.* case above.

[30] 1954 IRC § 62; cf. *Emily Marx*, 13 T.C. 1099 (1949); *Louis Drill*, 8 T.C. 902 (1947).

d. Records to sustain employee deductions. The Commissioner's rules with respect to these problems are rather strict. An employee is supposed to include all expense allowances and reimbursed expenses[31] in his gross income, and to the extent expenditures can be justified as business expenses by the employee, a deduction may be taken.[32] Thus, as a practical matter, it is well to require employees to account for expenses to be reimbursed because the employee must then keep records and the employer has an opportunity to review the expense account; if the employer under such circumstances reimburses the employee, a great stride forward has been taken in justification of the expenditure as a business expense.[33] If an employer pays expense allowances without accounting, the employer is required to file an information return on Form 1099, with a copy to the employee, if the amount exceeds $600 in the taxable year.[34]

While the keeping of accurate records is generally essential to the allowance of a full deduction to an employee for the expense, the absence of records is not entirely fatal if the employee can establish that some of the expenses were actually incurred for business purposes. In such cases, an allocation can be made, but it usually results that the allocation works unfavorably against the taxpayer.[35] An allocation, of course, would not and should not be allowed if the amount paid by the employer either as reimbursement or through a non-accountable expense account, or the amount expended by the employee without being reimbursed, appears to be in substantial part personal expenses. The King Committee, upon completion of its investigations, made as one of its recommendations that all estimated expense deductions not substantiated by accurate records should be disallowed, and that allocations and settlements in this area in the absence of records should be stopped. Such a policy might cure the disease but kill the patient. The specter arises of a businessman obtaining receipts from taxi drivers, waiters, hat check girls, pullman porters and others even more reluctant to sign their names. Or a deductible-minded businessman might present an invoice to a potential customer in the lobby of a hotel after completion of the evening's fun with a request for a receipt and certification that he is a potential customer and has been entertained with business in mind. The entertained would probably have no reluctance in signing because he, too, often entertains. Strict record requirements as an essential to such deductions might be the very path to satisfactory justification of all that the Treasury Department is now seeking to limit.

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[31] If the employer pays the amounts directly in the first instance, the employee need not include the expenditure in gross income. This procedure does not avoid the problem if the expenses are in fact personal, although it may be harder to detect them upon audit.

[32] Reg. 118, § 39.23(a)-2. If an employee can justify only a part of the deduction, the portion justified may be deductible. *Lanteen Medical Laboratories, Inc.*, 10 T.C. 279 (1948); *Hiram W. Evans*, par. 46,102 Prentice-Hall Memorandum (1946). See also *E. M. Godson*, par. 46,182 Prentice-Hall Memorandum (1946).

[33] See discussion above with respect to "reasonableness" and the Treasury Release, footnote 8, above, with respect to lavish expense accounts.

[34] Reg. 118, § 39.147-2. See Mim. 5947, 1945 C.B. 235 for interpretation of Regulations. But compare *Seven-Up Co.*, 14 T.C. 965 (1950).

[35] *Cohan* v. *Commissioner* (2 Cir. 1930), 39 F. 2d 540, 8 AFTR 10552. See also IR-Mim. 54-92 (May 25, 1954) for a general review by the Internal Revenue Service of its policy on the substantiation of claimed expenses. The approach there set forth emphasizes the over-all credibility of the taxpayer's statements and the reasonableness of his stated travel and entertainment expenses. The directive concludes with the warning that "it is not service policy to allow a percentage or other arbitrary computed portion of deductions of this character merely for the purpose of settlement."

5. Miscellaneous

There are a few special problems with respect to deduction of travel and entertainment expenses which bear noting. If a compromise or settlement of such deductions relating to a return filed for one year is under consideration along with other items in dispute, and there are later years unaudited where the circumstances with respect to the deductions are similar (i.e., poor or non-existent records), consideration must be given to the effect of the compromise or settlement upon the deductions in later years. Under such circumstances, the Treasury Department officials will be reluctant to settle later years on a more favorable basis than the earlier years.

A claim of excessive travel and entertainment expense deductions which cannot be justified by proper records may often have more far-reaching ramifications than the mere disallowance of the deductions. An examining agent, after discovering such deductions are unwarranted, will often examine the balance of the return more closely on the theory that a taxpayer who has taken improper deductions for travel and entertainment, may well have other vulnerable spots in his return. Upon completion of such an audit, a taxpayer may find the book has been thrown at him.

Contrary to a widespread impression, there is no rule of thumb as to a flat percentage of gross income which the Bureau will pass as business expenses without question.

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27

Fringe Benefits to Employees

HAL CANARY

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1. Points to Consider

The receipt by the employee of tax-free income has become a consideration of more importance than ever before in employer-employee relationships as the increasing cost of living and high income tax rates pinch the employee. At the same time, the employer is under compulsion to see that it gets full income tax deduction for any benefits to the employee. Some of the fringe benefits to employees that have been used by employers are the following:

	Section
Free food and lodging furnished employees	2
Executive dining rooms and employees' cafeterias	3
Group life, health, hospitalization insurance; medical check-ups; health, accident and sick benefit plans	4
Saving incentive plans	5
Non-taxable death benefits	6
Rental of employer-owned houses at cost and other expenses related to moving	7
Sale of junior equities and management stock to employees	8
Low-cost, or paid, vacations	9
Club dues and company-owned clubs	10
Education and scholarships	11
Ordinary professional services	12
Funds for rehabilitation of casualty losses	13

Major fringe benefits to employees, such as pension plans, profit-sharing plans, stock options, deferred compensation contracts, and travel and expense allowances, are considered elsewhere in this book and are not dealt with in this chapter.

2. Free Food and Lodging Furnished to Employees

Probably the original fringe benefit, recognized by Treasury Regulations long before that phrase became a part of income tax terminology, is the economic benefit to employees resulting from the furnishing of free food and lodging by the employer. Prior to the enactment of the Internal Revenue Code of 1954, there was no statutory provision for excluding such benefits from the employee's taxable income, but the regulations had granted that exclusion, subject to a single test,[1] for thirty-six years with little change.

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[1] Compare Reg. 45, Art. 33 (1918) with Reg. 118, Sec. 39.22(a)-3 (1953).

Through the years that test has been subject to varying interpretations, both administrative[2] and judicial.[3] As the pattern developed, the Tax Court appeared to divide its decisions on free food and lodging between the cases that followed the lines of the *Martin* case, where free food and lodging were considered a part of the compensation, as in the *Van Rosen*[4] case, and those that were more clearly for the convenience of the employer and benefits to the employee were incidental, as in the *Lees*[5] case.

The Internal Revenue Code of 1954[6] provides very definite tests for determining if meals and lodging shall be excluded from an employee's gross income. The meals and lodging must be furnished for the convenience of the employer. The meals must be furnished on his own business premises, and, in the case of lodging, the acceptance of the facilities must be a condition of employment. However, in determining whether meals and lodging are furnished for the convenience of the employer, employment contracts or state statutes fixing the terms of employment are not decisive, but cash payments in lieu of such facilities will be includible in the gross income of the employees, as will the value of such facilities furnished, if the employee has the option of accepting the facilities or receiving an allowance in addition to his regular salary.[7]

By the definite provisions of the 1954 Internal Revenue Code, free meals and lodging furnished employees have now taken their place in income tax law, along with pension, profit-sharing and retirement plans, stock options, etc. The tax treatment of free meals and lodging is now firmly grounded in the tax statutes and no longer will it be dependent on changing rulings and regulations.

3. Executive Dining Rooms and Employee Cafeterias

Search of the published rulings and decisions has not revealed any instances where the employer has been denied a deduction for the cost of meals furnished employees who do not live on the premises, although one dissenting opinion[8] has suggested that such costs be restored to the employer's gross income. It is no secret that many large employers take substantial losses on the operation of the employee cafeterias but count the money well spent since it results in employee good will, better morale, and more energetic workers because they are better fed. In such cases it is not practicable for the employer to report such expenses as paid to employees, nor to withhold income or payroll taxes, since no record is kept of the benefits received by each employee.

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[2] Mimeograph 6472, CB 1950-1, 15; Special ruling, issued November 3, 1950 (Prentice-Hall Tax Service, 1951-1, Par. 76,174) in reply to a request of the American Hotel Association, to the effect that the value of meals and lodging furnished by hotels to managers and assistant managers, including their families, is to be excluded from gross income if the employees are required to accept such benefits in order to perform their duties properly. To the contrary where agreements with an employees' union treats meals and lodging furnished as a factor in compensation.

[3] *Clifford Jones* v. *United States*, 60 Ct. Cls. 552 (1925), 5 AFTR 5297; *Ralph Kitchen*, 11 B.T.A. 855 (1928), where the Board of Tax Appeals found that rooms and meals were not furnished "solely" for the convenience of the employer since the taxpayer was not continuously on duty. The Tax Court announced in *Olin O. Ellis*, 6 T.C. 138 (1946) that it would no longer apply the "solely" test. See also *Herman Martin*, 44 B.T.A. 185 (1941).

[4] *Gunnar Van Rosen*, 17 T.C. 834 (1951).

[5] *Henry M. and Susan E. Lees*, Prentice-Hall Memorandum T.C., Par. 53,153.

[6] 1954 IRC, Sec. 119.

[7] Senate Finance Committee Report on H.R. 8300.

[8] *George A. Papineau*, 16 T.C. 130 (1951). The Court held that taxpayer, a partner in a hotel which he managed and which furnished his meals and lodging, could not realize income, ". . . the reason throughout being that one cannot employ or compensate himself." In his dissenting opinion, Judge Johnson pointed out that the proper adjustment was to restore the value of the meals to partnership gross income and to increase petitioner's share of the income from the partnership accordingly. The Commissioner has now announced his non-acquiescence and is following the dissenting opinion with the mitigation that the Bureau will accept a reasonable approximation of the costs attributable to such personal items. Rev. Rul. 80, CB 1953-1, 62.

Many corporations, too, maintain dining rooms for executives at which the executive may obtain meals at less personal expense than elsewhere, and in some cases at no expense to the executive. There is an added convenience to the employer in that the executive saves time by not leaving the plant, is constantly available for urgent calls, and can entertain his employer's customers in a more beneficent atmosphere than in a public restaurant. Doubtless many businesses lose money on their executives' restaurants, but it would be an ambitious revenue agent who would attempt to trace the loss as taxable income to the employees.

Even with the more clearly defined rules with respect to free meals found in the 1954 Internal Revenue Code, it is not anticipated that the Internal Revenue Service will challenge this practice that has become so much a part of American Business. The employer would have little trouble establishing a good business purpose, and the valuation problem would seem to discourage any attempt to tax the employee.

4. Group Life, Health, Hospitalization Insurance, Health Accident and Sick Benefit Plans; and Medical Check-ups

Although limited as to amount, group insurance is the best buy taxwise that an employer can make for his employees. The employer gets a full deduction, and if the group insurance is term life insurance, health or hospitalization insurance, there is never any tax to the employee, or to his beneficiary,[9] the theory being that with term insurance there is never any certainty that the employee will receive any benefits because he may leave his employer's service, or the employer may stop paying the premiums.

In the past there has long existed confusion and disagreement over the taxability of employees on employer-paid accident, health, and sick benefit coverage of employees and benefits received by the employees, where the coverage was not through group policies. The Internal Revenue Service announced [10] that, "Pending further clarification by the Congress," it would not follow the Seventh Circuit's *Epmeier*[11] decision.

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[9] Reg. 118, Sec. 39.22(a)-3; Rev. Rul. 54-165, I.R.B. 54-20, 6. From Merten's Law of Federal Income Taxation, Vol. 1, Sec. 8.05, p. 380: "For some reason that is not clear, the Treasury Department has failed in the case of group life insurance and retirement annuity plans to present with vigor the application of the equivalent of cash doctrine, although it has with other connections urged, and been successful in applying the doctrine of flow of satisfaction or benefit with a view to accelerating the realization of income." (See 1939 IRC, Sec. 22(b)(2)(B) and 1954 IRC, Secs. 72(d) and 402(b) for change in taxability of retirement annuity plans.)

[10] Treas. Rel., I.R.-047, March 26, 1953.

[11] *Arnold W. Epmeier* v. *U.S.*, 199 F. 2d 508 (1952), 42 AFTR 716.

In the 1954 Internal Revenue Code, Congress did set out definite rules[12] which provide that employees are not to be taxed on any employer contributions to an accident or health plan, whether insured or uninsured. Moreover, the plan does not have to meet any special tests to qualify payments for exemption. The exemption for insurance premiums on health or accident policies applies both to individual and group policies.[13] The benefits, when received by the employee, are exempt if they constitute reimbursement for medical expenses for himself, his wife, or his dependents, provided he did not take a medical deduction for the expenses covered. Reimbursement for loss of wages up to $100 per week are also exempt if the employee was absent from work due to injury or sickness. However, there is a 7-day waiting period in the case of payments during illness, unless the employee is hospitalized for at least one day during the period of absence. This waiting period does not apply to absence due to injury.

By the simple expedient of keeping proper and adequate records, the employer can give the employee an immediate benefit by excluding from wages subject to withholding payments up to $100 a week for loss of wages due to injury or sickness.[14]

In recent years, large corporations have begun to realize the investment they have in top level personnel and have instituted "maintenance" programs with the hope of lengthening the periods of service. This, of course, is for the employer's benefit and at the employer's expense, but the executive who gets a thorough medical check-up has been saved money he would have had to pay out himself with extremely valuable after-tax dollars. Apparently no situations of this kind have been questioned by the Internal Revenue Service, or at least none of them has reached the courts. In a slightly similar situation[15] the employer was permitted to deduct the expense of medical bills of approximately two thousand dollars but the Tax Court found the amounts represented additional compensation to the employee.

5. Saving Incentive Plans

Many employers have been willing to further employee relationships by permitting employees to share in the profits during periods of prosperity (and high taxes) but have wanted to avoid having the necessary cost become a part of their permanent salary-wage scales, or committing themselves to payments in future years, as under a pension trust or retirement annuity plan. In such cases employers have turned to one of the various types of profit-sharing plans. One popular plan has solved the problem by combining profit-sharing with an employees' saving plan, thus encouraging each employee to provide for his own future.

In the usual plan of this type, all employees are eligible, ordinarily after a specified length of service. Membership in the plan is voluntary, each employee joining by having a percentage of his base pay deducted and paid to a trustee. The employee's contribution may vary from 1% to 10% of his base pay, the option sometimes depending upon his number of years with the employer. The total amount that may be deposited by the employee is limited to prevent too great a proportion of the employer's contribution from going to highly paid employees. The employer makes a contribution, the amount of which is based on a profit formula, usually excluding capital gains, and providing for the contribution of a percentage of profits after a specified return on net worth, or a definite amount per share has been set aside for the owners.

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[12] 1954 IRC, Secs. 104, 105, 106.

[13] See footnote 7, above. Compare with Rev. Rul. 20, CB 1953-2, 114 applicable to 1939 Code.

[14] Reg. 120, Sec. 406.207.

[15] *Mary Sachs,* Prentice-Hall Memorandum T.C., Par. 52,256 (1952), vacated and remanded on other issues by 3 Cir., 208 F. (2d) 313 (1953), 1953 Prentice-Hall, Par. 72,782.

The amounts paid in by the employee, plus earnings on these deposits, are the property of the employee, and may be withdrawn when he leaves the employer. The amounts contributed by the employer, and the earnings on such amounts do not vest in the employee until after a specified period, or at a definite percentage each year, with complete vesting usually after ten years. Costs of administering the plan, which involve keeping an account with each employee are usually borne by the employer. Trust funds may be invested by the trustee without regard to the types of investments permitted trusts by state law, but disproportionate investment of trust funds in securities of the employer will be questioned by the Treasury Department.

6. Non-taxable Death Benefits

One of the fairly recent provisions in the revenue law[16] permits the payment of $5,000 tax free as a death benefit to the family of a deceased employee. The 1954 Internal Revenue Code limits this exclusion to $5,000 for each employee from all employers, but liberalizes the provision in that there need be no contractual liability of the employer to pay the amount. The payment will be tax-free even though made voluntarily after death of the employee. Under the 1954 Internal Revenue Code, the exclusion is also extended to distributions from qualified pension plans, profit-sharing, and stock bonus plans, even though the employee had a non-forfeitable right to the amounts while living.

Since enactment of the Revenue Act of 1951 many corporations have added to their employment contracts this stipulation which will give the heirs of their key personnel $5,000 not subject to Federal income tax. Some of the officers of multiple corporation organizations have taken contracts from several corporations of which they are officers, each of which provides for the $5,000 death benefit. While these contracts may result in a material saving in the cost of life insurance the employee must carry to protect his family, the change made by the 1954 Internal Revenue Code, which limits the exclusion to one $5,000 payment, may result in almost prohibitive income taxes on the additional contracts, depending on the income tax bracket of the beneficiary in the year, or years, in which the payments are received.

In some situations the advantages of even a single contract of this kind may be less liberal than might be expected—depending upon the size of the employee's estate. In a 1952 ruling[17] the Treasury Department held that where an employee had the right to designate the beneficiary of a death benefit under a profit-sharing and retirement plan, the employee, at the time of his death, is in possession of such rights as constitute property within the meaning of the estate tax laws, provided that prior to the employee's death the employer had not withdrawn the right of the employee to designate a beneficiary and had not eliminated the death benefit. It can easily be seen that if the Internal Revenue Service is successful in enforcing this rule in estate taxation, it may try to extend it to cover payments described in 1954 Code Section 101(b) and 1939 Code Section 22(b)(1)(B). In any case the tax adviser will do well to consider possible estate taxes that could result from the $5,000 contractual death benefit.

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[16] 1939 IRC, Sec. 22(b)(1)(B) enacted by Sec. 302 of the Revenue Act of 1951, effective for years beginning after December 31, 1950. 1954 IRC 101(b), effective as to payments received by reason of death of an employee occurring after August 16, 1954.

There appears to be no basis for the inclusion in the employee's estate of a voluntary payment by the employer to the decedent's beneficiary since the employee had no rights that would constitute property at the time of his death. If the payments in excess of $5,000 are paid under a contract, they are clearly taxable and there should be no question as to their deductibility by the employer. However, if the payments are voluntary, there may be questions of taxability to the employee's beneficiary[18] of payments over $5,000 and of deductibility by the employer[19] of any of the payments.

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[17] G.C.M. 27242, CB 1952-1, 160. But see *Estate of John C. Morrow*, 19 T.C. 1068 (1953), acquiescence I.R.B. 54-16, 5.

[18] If payments to a deceased employee's dependents are not made because of a contract or understanding with the employee, the Tax Court holds the payments to be nontaxable gifts. This is true even though the payments continue for an extended period after the employee's death. *Louise K. Aprill*, 13 T.C. 707 (1949), *Alice M. Macfarlane*, 19 T.C. 9 (1952), *Ruth Hahn*, Prentice-Hall Memorandum T.C., Par. 54,103 (1954).

However, the Bureau disagrees with the court. It formerly held that salary payments voluntarily continued for a limited period (approximately two years) after the employee's death were nontaxable. I.T. 3329, CB 1939-2, 153; O.D. 1017, CB 5, 101 (1921). It subsequently revoked this ruling to hold that payments received by an employee's widow after 1950 and made in consideration of the employee's services are taxable "irrespective of a 'plan' voluntary or involuntary, definite or indefinite." I.T. 4027, CB 1950-2, 9; "Your Federal Income Tax," 1952 ed., p. 39.

The courts hold that continued salary payments to the estate of a deceased employee, rather than to dependents, are taxable even though the employer corporation is not obligated to make them. *Lincoln D. Brayton* v. *Welch*, 39 F. Supp. 537 (1941), 28 AFTR 43; *Estate of Edward Bausch*, 14 T.C. 1433 (1950), aff'd 186 F. 2d 313 (2 Cir. 1951), 1951 Prentice-Hall Tax Service, Par. 72,272.

[19] The Treasury states that an employer may continue to pay the employee's salary or pension to the widow—not in excess of the employee's salary or pension—and the amount may be deductible for a limited period after death as an ordinary and necessary business expense even if the payments are voluntary. Reg. 118, Sec. 39.23(a)-9; I.T. 3329, CB 1939-2, 153. And the limited period will usually be not more than two years. "Your Federal Income Tax," 1946 ed., p. 63; *McLaughlin Gormley King Co.*, 11 T.C. 569 (1948); Rev. Rul. 54-625, 1954-2 CB 85, modified by Rev. Rul. 55-212, I.R.B. 1955-15, 11.

Because the Treasury itself gives a tax break for voluntary pensions made for a limited period, the courts have not had to pass on the validity of this position. But where the taxpayer has claimed a deduction beyond the limited period, the Tax Court has consistently disallowed the claim unless it could be shown to be for past services and reasonable in amount. *Mobile Bar Pilots Ass'n*, 35 B.T.A. 12 (1936); *W. D. Haden Co.*, Prentice-Hall Memorandum T.C., Par. 46,089 (1946), aff'd on other issues 165 F. 2d 588 (5 Cir. 1948), 36 AFTR 670. *McLaughlin Gormley King Co.*, Supra; *I. Putnam, Inc.*, 15 T.C. 86 (1950); *Philadelphia-Baltimore Stock Exchange*, 19 T.C. 355 (1952).

The Tax Court has quite clearly indicated that it is only the regulations provision and the

7. Rental of Employer-Owned Houses at Cost and Other Expenses Related to Housing

As noted in Section 2 of this chapter, housing can be furnished the employee without its value being included in the employee's gross income, only if the accommodation is for the employer's convenience. When the employee occupies employer-owned property for his own convenience, the rental value is taxed to him as compensation.[20] Since shortage in housing usually accompanies a tight labor market, some employers have improved their situation by acquisition of housing facilities which are rented to the employee at cost. Where the employee has purchased his own home, the employer has sometimes loaned the employee the money at the same rate of interest the employer is currently paying, usually less than the employee would pay on a real estate mortgage, not taking into consideration the saving in cost by paying cash for the property.

Where the employee had sold his home pursuant to orders from his employer to move to another location, the loss on the sale of his home was borne by the employer, and the employee was not taxed on the employer's payment as compensation.[21] It was held that the employer had furnished only a sufficient part of the sale price to compensate the employee for the loss sustained on the sale. The Tax Court has held, however, that where the employer paid a part of the purchase price of a home, where the employee having changed locations could not find suitable rental property, the payment was additional compensation, taxable to the employee.[22] In the former case, the employer deducted the payment as "sundry other expense"; in the latter case, as "payroll expense."

While moving expenses paid by the employee in moving from one job to another are not deductible when paid by the employee, it is common knowledge that it is customary for many employers to pay moving expenses of employees and their families when they are transferred. The Bureau has approved this practice and has ruled that payment or reimbursement by an employer of the cost of moving an employee from one official station to another for permanent duty does not constitute income to the employee.[23] The ruling is limited to transfers of employees and does not cover moving expenses of new employees.

8. Sale of Junior Equity Stocks to Employees

The employer may, in some cases, increase the earnings of selected employees, but not their taxable incomes, through a plan for purchase by those employees of

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Treasury practice that permit employers to deduct voluntary payments to widows for a limited period without meeting the tests of additional compensation for past services. If the Commissioner should ever change his ruling, the Tax Court would apparently grant no special break to payments even for a limited period.

[20] *Percy M. Chandler* v. *Commissioner*, 119 F. 2d 623 (3 Cir. 1941), 27 AFTR 172, overruling *Hillman* v. *Commissioner*, 71 F. 2d 688 (3 Cir. 1934), 14 AFTR 318, and differing with *Richards* v. *Commissioner*, 111 F. 2d 376 (5 Cir. 1940), 24 AFTR 931.

[21] *Otto Sorg Schairer*, 9 T.C. 549 (1947).

[22] *Jesse S. Rinehart*, 18 T.C. 672 (1952).

[23] Rev. Rul. 54-429, I.R.B. 1954-40, 15.

junior equity, or management, stocks. This may be done by outright sales of unrestricted stock with the employee paying for it over a long period, with or without interest, or the sale of the stock to an employee to be paid for by a loan from the employer, with the stock as security for the loan, which it is expected will be liquidated by dividends.

In an established business, the conventional type of junior equity, or management stock, usually has a more than nominal value because of the high potential earning value, and consequently, upon the purchase thereof the employee may realize taxable income at the time of purchase.

But even in an established business, where potential appreciation in the value of the shares is indicated, there is a variation of this junior equity stock plan which can substitute for a deferred profit-sharing plan in that it will result in capital gain to the employee at such time as the stock is sold. Unfortunately, the effective use of this method is usually limited to closely held corporations. It involves an amendment to the corporation's charter to provide for:

First, a new class of capital stock which may be designated as Class B common stock, with nominal par or stated value. The stock can be voting, or non-voting. It shall be issued only at specified dates, and will not share in earnings accumulated prior to its issuance.

Second, the charter will provide for the allocation of future earnings between the Class A, or original stock, and the various issues of Class B stock, but all classes of stock will share in the earnings, in designated percentages. Dividends may be declared on either class of stock, or on both classes of stock, to the extent of the surplus allocated to each class, or block, of stock. The dividends need not be declared simultaneously; they may be declared regularly on one class of stock and not at all on the other class.

Concurrently with the issuance of the Class B common stock the corporation can enter into an agreement with the employee whereby it is agreed that if the employee should desire to sell his Class B stock, or if he should leave the employ of the company within a specified time, he must offer his stock to the company, which may purchase the stock at book value. Since the sale of the stock is restricted, the price for which the employee can sell the stock immediately is book value.

This junior equity stock can be of use as well for taking care of stockholders who are not employees, and who do not draw salaries from their corporations. In many closely held corporations, the officers draw liberal salaries and are not particularly interested in distributions of earnings, the major part of which would go for income taxes. On the other hand, there are frequently small stockholders who do not have large incomes and they usually want the profits distributed liberally and regularly.

Since both Class A and Class B stocks are common, the exchange of one for the other is non-taxable[24] and the shareholders preferring dividends can exchange their Class A stock for Class B stock and draw dividends; the shareholders who would prefer that earnings accumulate, can exchange their Class B for Class A stock, and await capital gains.

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[24] 1939 IRC, Sec. 112(b)(2); 1954 IRC, Sec. 1036(a).

9. Low-Cost or Paid Vacations

Vacations, the expense of which is paid by the employer, may be said usually to result in additional compensation to the employee, if allowed as a deduction to the employer. There is, however, a reported case to the contrary.[25] Amounts expended for recreation centers[26] and other facilities for the comfort, pleasure, or entertainment of the employees have been allowed as deductions to the employer where it is clearly evident that such expenditures have been for the benefit of the employees, and not exclusively for the owners, officers, directors, or other executives. It is well known that the Internal Revenue Service has approved settlements which allowed that portion of the expenses of company-owned clubs, recreation centers, yachts, etc. which was applicable to use by the employees and customers. On the other hand, the Internal Revenue Service has not only disallowed the expenses when the facilities have been used by the officers-stockholders, but has treated such expenditures as dividends, taxable to the beneficiaries, and not deductible by the employer.

Corporation executives are constantly being offered ways of entertaining the firm's employees or customers with the assurance that expense of the plan is "fully deductible from taxable income." Typical of these plans is one where a real estate promoter is offering to lease to business firms, on a five-year basis, a private villa on Florida's East Coast.[27] The advertisements assure prospects that if properly used for the benefit of employees and customers, the expense is fully deductible. Three ways of using the leased property are suggested: (1) As an employee relation technique, rewarding winners of suggestion box competitions, winners of plant safety campaigns, sales quota leaders, or merely renting the villa to the employee at cost for vacations, etc.; (2) As a vacation home for executive and key personnel; and (3) As a vacation home for customers and close friends of the company.

The use suggested in (1) above will result in taxable income to the employees insofar as it is in the nature of compensation, bonus, or reward;[28] rental of property to employees at cost would, of course, not have that consequence. Unless a substantial amount of business is mixed with pleasure in the use suggested in (2) above, the executive and supervisory personnel, if non-stockholders, will probably be held to have received additional compensation; or dividends, if stockholders.

It is a matter of general practice, the result of which still remains to be determined, that many corporations have arranged trips for their executives, which may be largely for business reasons, to vacation centers, or to Europe, which are planned to be in part vacations for the executive, as well as productive to the employer.

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[25] *McCoy-Brandt Mach. Co.*, 8 B.T.A. 909 (1927). In this case the taxpayer was contending with a shortage of skilled labor and paid a part of the vacation expenses of certain of its employees in order to retain their services. Held, the amounts so expended were deductible as ordinary and necessary expenses. It is likely that in those years the employees would not have been subject to income tax even if the vacation payments had been held to be additional compensation, which they were not.

[26] *Slaymaker Lock Co.*, 18 T.C. 1001 (1952), Acquiescence I.R.B. 1953-14, Rev'd on other issues, 208 F. 2d 313 (3 Cir. 1953), 1953 Prentice-Hall, par. 72,782.

[27] *Business Week,* October 16, 1954.

[28] 1954 IRC, Sec. 74(a).

As in travel and entertainment expense questions, the final determination will depend upon the records—whether it can be shown that the expenditure was clearly connected with the business, whether it resulted in profits, even if intangible, to the employer, and if the amounts expended are unquestionable.

10. Club Dues and Company Owned Clubs

Dues paid by individuals for memberships in social clubs, country clubs, etc. are usually considered personal expenses, not deductible for income tax purposes unless the membership was purchased for business reasons and the evidence shows that it was so used. The same is true of expenditures by the employer where the membership is in the name of the employee. Whether or not certain expenditures are deductible as "ordinary and necessary expense" is a question of fact. Where the employer, or the employee, is able to show that the club membership was used to make contacts which actually produced business, ". . . the Government cannot refuse to allow plaintiff a deduction as a business expense of the money which produced the business." [29]

Probably in better position to defend country club expenditures are the employers who are able to own golf courses, etc. for exclusive use of their employees, as is reported of an aluminum company.[30]

11. Education and Scholarships

Company-sponsored educational programs are widely publicized today. They range from short courses at universities for top-level executives, to refresher courses for technicians, and to training programs and trade schools for wage earners. Ambitious workmen are encouraged to take courses, usually paid for by the employer, to fit themselves for supervisory work. Such fringe benefits may produce profitable results for the employer, without tax cost to the employees. It is not believed that the provisions of the 1954 Code[31] with respect to scholarships were intended to cover courses such as those mentioned above, but that the cost of those courses should be deductible by the employer as an ordinary and necessary expense from which some benefit will be realized. It should also be possible to show that the primary benefit is intended for the employer and that any benefit realized by the employee is of an incidental nature. In this connection it is noted that Internal Revenue Service has contracted for advanced training of 500 internal revenue agents each semester at a state university.[32] It has not been announced whether the tuition, which will be paid by I.R.S., will constitute taxable income to the agents.

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[29] *Todd W. Johnson* v. *United States*, Sou. Dist. Cal., 45 F. Supp. 377 (1941), 29 AFTR 841, Reversed and remanded without discussion of this point by 9 Cir. 135 F. 2d 125, 30 AFTR 1393.

[30] *Time*, August 24, 1953.

[31] Sec. 117.

[32] *The Wall Street Journal*, August 25, 1954; *The Journal of Accountancy*, September, 1954, p. 270.

12. Ordinary Professional Services

It has long been the practice of employers with large numbers of employees to arrange with certified public accountants to stay at the plant during the tax return filing period for the convenience of the employees in the preparation of tax returns. This saves time the employees would otherwise have to be absent.

In many instances medical advice has been made available to the employees without the necessity for leaving the job for any length of time. *The Wall Street Journal* quotes the head of the Massachusetts Chiropodists Association as claiming that absenteeism may be cut as much as 50 per cent by proper foot care.

Company employed attorneys are frequently used to advise employees with regard to minor legal problems which may be troubling the employee, inexperienced in such matters.

While these extraordinary services furnished by the employer cost him but little, they serve to improve relationships with employees and assure the employer a better supply of labor in times of full employment.

13. Funds for Rehabilitation of Employees' Casualty Losses

A 1953 ruling may have opened the way for a more liberal and humane policy on the part of the Treasury Department with respect to fringe benefits to employees. Rev. Rul. 131, C.B. 1953-2, 112, announced

> Amounts contributed by the taxpayer to promote the rehabilitation of its employees and their families who sustained injuries or damages in a tornado are deductible under section 23(a)(1)(A) [Section 162 of the 1954 Internal Revenue Code]. Since such contributions are not related to services rendered but are based solely on need, they do not constitute income to the employees for Federal income tax purposes.

The ruling makes the point that the maintenance of good will of a community in which a business enterprise has its establishment is of prime importance to the enterprise because of the effect on its progress and on its income. It has a direct bearing on the retention of the employees' good will and the morale of the employees, which in turn are essential to the successful conduct of the business. While the ruling cites *Corning Glass Works* v. *Lucas*[33] and *Sugarland Industries* v. *Commissioner*,[34] both of which dealt with contributions to community hospitals, it also cites *Slaymaker Lock Co.* v. *Commissioner*.[35] In the last named case, the corporate taxpayer expended certain amounts for the purchase and improvement of a recreation lodge which it gave to its foremen's association. The Commissioner attempted to capitalize the expenditure but the Tax Court pointed out that the taxpayer no longer owned the property.

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[33] (D. of C. Cir. 1929) 37 F. 2d 798, 8 AFTR 10053. This case is cited as a borderline case in *Welch* v. *Helvering*, 290 U.S. 111, 12 AFTR 1456 (1933) affirming 63 F. 2d 976, 12 AFTR 348 (8 Cir. 1933), affirming 25 B.T.A. 117. In the *Welch* case the taxpayer claimed a deduction for payment of debts of a corporation after its discharge in bankruptcy, the payments having been made to re-establish his credit. The Supreme Court held, in part, "Reputation and learning are akin to capital assets, like the good will of an old partnership. . . . For many they are the only tools with which to hew a pathway to success. . . . The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business."

[34] 15 B.T.A. 1265 (1929), Acquiescence VIII-2 C.B. 50.

[35] Footnote 26, above.

It should be noted that in the ruling quoted above, the Treasury Department has used the expression "maintenance" of good will and "retention" of good will, rather than the *acquisition* of good will. A contribution to victims of a tornado is certainly not an ordinary expense, but if it maintains or retains good will, it may be considered a necessary expense. If the fringe benefit is one that the taxpayer's policies in the past have led the employees and the community to expect, it may receive different treatment from the Treasury Department than would an unusual expenditure designed to create good will *de novo*.

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28

How to Get the Maximum Deductions for Repairs

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A clear understanding of the principles involving the deductibility of expenditures for repairs is of greater importance than reference to what the courts have held with respect to similar or even identical property in other cases. Armed with such an understanding of principles it becomes possible to secure the maximum deduction for repairs. The purpose of this chapter is to discuss these controlling principles in order that the reader might gain a better understanding of how the varying circumstances control the deductibility of expenditures for repairs.

1. Points to Consider

Section
What are maintenance expenses and what are capital expenditures? 2
How the law and regulations provide for repair deductions 3
How does the amount spent on repairs affect deductions? 4
How does the frequency of repairs affect the deduction? 5
How to get deductions for repairs made simultaneously with improvements 6
When is the life of an asset prolonged? 7
What is the exception to the general rule on repairs? 8

2. What Are Maintenance Expenses and What Are Capital Expenditures?

Our purpose here is to determine where to draw the line between expenditures which are deductible as repairs and expenditures for somewhat related purposes which nevertheless must be capitalized. Oliver Wendell Holmes once said that where to draw the line is the question in pretty much everything worth arguing in the law. Day and night, youth and age were suggested by him as but types. (*Irwin* v. *Gavit,* 268 U.S. 161, 168.)[1] Little difficulty is experienced at the extremes. Obviously, difficulties multiply as we approach the line itself. In the case of repairs, an inconsistent overlapping is sometimes evident in particular decisions. Perhaps the presence of some human element might explain such inconsistencies. As a result, therefore, we find that expenditures which apparently should have been allowed, sometimes have been disallowed; while others, of a type which should have been disallowed, sometimes have been allowed. Compare, for example, *P. Dougherty & Co.*,[2] with *Zimmern* v. *Commissioner*.[3] Both of these cases involved repairs to barges. In the Dougherty case, the cost of replacing a rotted stern was disallowed on the ground that the repairs prolonged the life of the vessel. It is difficult to see how the life of the major portion of the vessel, which was not repaired, could have been prolonged by the temporary expedient of repairing only the stern.

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[1] *Irwin* v. *Gavit,* 268 U.S. 161, 168.

In the Zimmern case, the repairs allowed were made by the taxpayer upon purchasing a sunken vessel from a salvage company for the purpose of rehabilitation and use. The vessel was over 60 years old when sunk and had lain under water for two years when purchased. This decision has been cited with approval by the Tax Court in *American Bemberg Corporation*[4] (aff'd. 177 Fed. 2d 200). The holding in the Zimmern case is apparently contrary to the well-recognized accounting principle that when partly worn-out or run-down properties are purchased with an intention by the new owners to rehabilitate them, so that they can be operated efficiently, it may be assumed that the purchase price takes into consideration the poor condition of the plant. Under these circumstances, the entire cost of repairs and renewals necessary to bring the plant to a satisfactory operating condition ordinarily has been capitalized.[5] However, repairs that are clearly ordinary and necessary will not be disallowed for the sole reason that they were made soon after the acquisition of the property.[6]

The deductibility of repairs is controlled generally by whether the item is essentially a maintenance item or a capital item. The old Bureau of Internal Revenue Bulletin "F" (revised January 1942), however, authorized some latitude in the application of this rule. On page 11, dealing with depreciation, the Bulletin recognized that "the taxpayer's operating policy and the accounting policy followed with respect to repairs, maintenance, replacements, charges to capital-asset account, and to the depreciation reserve" have a material bearing upon the question of whether or not certain repairs of such taxpayers should be capitalized and recovered through depreciation allowances, or deducted as business expenses.

In line with the principle that deductibility depends primarily upon whether the item is essentially a maintenance item or a capital item, repairs which are incidental to and necessitated solely by virtue of a substantial capital replacement, must be capitalized. For example, repairs to and moving of facilities incidental to the replacing of an entire new and stronger floor, must be capitalized as part of the cost of the new floor. *The Phillips and Easton Supply Company*, 20 T.C. 455.[7]

From the foregoing, it is obvious that repairs are not readily susceptible of division into two opposite categories, one deductible and the other not deductible, depending upon the physical description of the property. A general description of the particular repair job constitutes only one of the factors material to deductibility. As stated above, deductibility depends upon whether the item is essentially a maintenance item or a capital item. Repairs involving improvement of the property must be capitalized. The word "improvement" in this sense means something more than the improvement that must necessarily follow any repair designed to overcome current or even recent depreciation.[8] For example, cases have disallowed the replacement of iron piping with brass piping[9] and the replacement of wooden beams with iron girders.[10] Although "replacements" generally are regarded as capital items rather than deductible repairs, this classification applies principally to the "replacement" of an entire "unit," or a very substantial portion of an entire "unit." A different situation, however, exists with respect to expenditures involving the replacement of small parts of large machines necessitated in order to maintain such machines in an efficient working condition. The replacing of small parts as they wear out would be regarded as repairs rather than non-deductible "replacements." [11] Such replacements are not "replacements" in the capital sense. They are essentially maintenance items and therefore constitute deductible expense.

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[2] 5 T.C. 791 (1945), affirmed (4 Cir. 1947) 159 F. 2d 269, cert. den. 331 U.S. 838 (1947).

[3] (5 Cir. 1928) 28 F. 2d 769.

[4] 10 T.C. 361, 377 (1948), affirmed without opinion (6 Cir. 1949), 177 F. 2d 200.

[5] See Montgomery, *Auditing*, Seventh Edition, page 232. New York: The Ronald Press, 1949. See also H. Wilensky & Sons, Co., 7 B.T.A. 693 (1927); and *California Casket Co.*, 19 T.C. 32, acq. 1953-1 C.B. 3.

[6] *Osage Steamship Co., Ltd.*, 3 B.T.A. 141 (1925).

[7] *The Phillips and Easton Supply Company*, 20 T.C. 455.

Here common sense and accounting consistency are indispensable ingredients. The general attitude is that the "replacement" of a "unit" of property must be charged to capital account. What is a "unit" in this sense depends upon whether or not the particular item is one of "major" or "minor" importance. If of "major" importance, the item becomes a "replacement," while if the item is of "minor" importance it does not rise to the dignity of a "unit," and if replaced in kind, without betterment, its substitution constitutes deductible maintenance. Good accounting practice has recognized the propriety of drawing a line at some arbitrary money value below which replacements, even of items involving some betterment, may be charged to mantenance pursuant to a consistent policy. See Kester, *Advanced Accounting*, Ch. 1, "Treatment of Renewal Parts," and Ch. 14, "Parts Replacements." In this regard the Internal Revenue Service has refrained from disturbing replacement items without betterment, costing $100 or less, permitting them to stand pursuant to the taxpayer's consistent policy of deducting such items as maintenance. In this sense accounting consistency requires that the treatment of such items is regarded as having a direct bearing upon the depreciation rate. If such "minor" items are consistently capitalized, the depreciation rate must be larger, while if they are consistently expensed, it should be reduced consistently with such practice. A very careful study of the many cases bearing on the treatment of particular kinds of borderline items indicates that the cases themselves are often irreconcilable and hence of little assistance in attempting to arrive at any usable rule of thumb.

Deductible repairs, in the case of larger units for which separate accounts are consistently maintained, may be said to be such repairs as are necessary to prevent the unit from being abandoned or scrapped prior to the termination of its normal useful life expectancy. See *Farmers Creamery Co. of Fredericksburg, Va.*, 14 T.C. 879.[12] Repairs in the nature of replacements of substantial units separately capitalized on the taxpayer's books or records, or repairs which have the effect of appreciably prolonging the life of such property beyond the normal useful expectancy, therefore, are not deductible. Such repairs either should be capitalized or charged against the depreciation reserve. In view of the borderline nature of many repair items that might be regarded either as maintenance repairs or as repairs in the nature of replacements, the taxpayer's consistent treatment of such items may become material in determining whether the item should be capitalized, be charged against a depreciation reserve, or be expensed. The distinction between "repair" and "replacement" is "one of degree rather than of kind." [13]

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[8] See *Libby & Blouin, Ltd.*, 4 B.T.A. 910 (1926).

[9] *Fire Companies Building Corp.*, 18 B.T.A. 1258 (1930).

[10] *Consumers Ice & Cold Storage Co.*, 6 B.T.A. 1269 (1927).

[11] *Libby & Blouin, Ltd.*, 4 B.T.A. 141 (1925).

[12] *Farmers Creamery Co. of Fredericksburg, Va.*, 14 T.C. 879.

The leading case involving the deductibility of repairs for income tax purposes is *Illinois Merchants Trust Co.* In that case, the Tax Court laid down the principles involved in language which has been quoted many times since.[14]

3. How the Tax Law and the Treasury Regulations Provide for Repair Deductions

Repairs are deductible from gross income as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" under Section 162(a). Repairs that constitute ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, and maintenance of property held for the production of income are deductible in the case of an individual within the meaning of Section 212(1) and (2). The word "repairs" itself does not appear in the statute. Deductions for repairs, however, have become embodied in former income tax laws through the Regulations, which have acquired the force and effect of law.[15]

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[13] *Buckland* v. *U.S.*, 66 F. Supp. 681, 683 (1946), 35 AFTR 161.

[14] The court said:

". . . In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinary efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacement, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings. . . ." 4 B.T.A. 103, 106 (1926).

[15] Reg. 118 Sec. 39.23(a)-4. The Regulations on repairs had their inception thirty-five years ago in Article 131 of Regulations 33. The corresponding provision in Regulations 45 under the Revenue Act of 1918, namely, Article 103, has remained substantially unchanged in meaning up to and including the current wording which is as follows:

"The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the *cost of acquisition or production or the gain or loss basis of the taxpayer's* plant, *equipment*, or *other* property, *as the case may be*, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve *if such account is kept*." (The italicized words "if such account is kept" were first added by Article 103 of Regulations 62, and the other italicized language was added, and the word "account" was omitted by Sec. 39.23(a)-4 of Regulations 118.)

4. How Does the Amount Spent on Repairs Affect the Deduction?

The Regulations, both as to repairs and depreciation, mention "incidental repairs." This expression in the Regulations on occasion has lead the Internal Revenue Service to take the position that the phrase "incidental repairs" limits the deduction to expenditures for keeping the property in an ordinarily efficient operating condition in order to overcome wear and tear and trifling accidental causes.[16] However, the test of the deductibility of a repair, which does not substantially prolong the life of the property, does not necessarily turn upon the relative magnitude of the expenditure.

In *American Bemberg Corp.*,[17] litigation involving the deductibility of expenditures for repairs of great magnitude was decided favorably for the taxpayer. The decision was based upon an analysis of the meaning of the basic statutory phrase "ordinary and necessary" under which repairs are deductible expenses. It is believed that the decision in this case constitutes a practical refutation of the Government's "trifling accidental causes" position as to the meaning of the words "incidental repairs." In that case, the Tax Court, relying on *Illinois Merchants Trust Co.*,[18] and *Welch* v. *Helvering*,[19] allowed the taxpayer to deduct nearly a million dollars for drilling and grouting as "ordinary and necessary" business expenses. During the years 1925 to 1928 petitioner had built, under the supervision of competent engineers, a large rayon plant not far from a river in Tennessee. During 1940 and 1941 major cave-ins occurred beneath the plant, necessitating the subsoil engineering programs of drilling and grouting for which the expenditures in issue were made. It was held that the carrying out of this program was an expedient "necessary" to prevent the abandonment of the plant, and was "ordinary" in the sense that it was a "normal response" to the need developed by the cave-ins.[20]

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[16] See *Hubinger* v. *Commissioner* (2 Cir. 1930), 36 F. 2d 724, 726, cert. den. 281 U.S. 741, 8 AFTR 9906.

[17] Footnote 4, above.

[18] 4 B.T.A. 103 (1926).

[19] 290 U.S. 111 (1933).

[20] The Government argued in the Court of Appeals that although the program was "necessary," it was not "ordinary" in the sense used in the statute and therefore represented a capital item. It argued that the word "ordinary" had "the connotation of normal, usual or customary," citing *Deputy* v. *Du Pont*, 308 U.S. 488, 495, (1940), 23 AFTR 808, and *Hales-Mullaly* v. *Commissioner* (10 Cir. 1942), 131 F. 2d 509, 512, 30 AFTR 313.

It pointed out that the Regulations do not allow all repairs as deductions but only "incidental repairs" and that in *Hubinger* v. *Commissioner* (2 Cir. 1930), 36 F. 2d 724, 726, 8 AFTR 9906, it had been said that ordinary expenses in the most natural meaning of the words are those due to wear and tear and "trifling accidental causes."

Although the Government cited and quoted from the decision of the Supreme Court in *Welch* v. *Helvering*, 290 U.S. 111 (1933), it wholly ignored the fact that in the opinion of Justice Cardozo, the following important statements were made:

"Ordinary" in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, *whether the amount is large or small, are the common and accepted means of defense against attack.*" (Italics supplied.)

This dictum was followed and literally applied by the Supreme Court in *Commissioner* v. *Heininger*, 320 U.S. 467 (1943), 31 AFTR 783 in allowing certain legal expenses as "ordinary and necessary."

It is the *expenditure* which must be "ordinary" and not the *circumstance* that *gave* rise to the expenditure. The question is, when you are faced with an unusual or unique circumstance arising in a business: Do men ordinarily make the expenditure necessitated by the circumstance? In other words, what is "the common and accepted means of defense against attack" under such circumstances?

This thought is further emphasized by the unique and unusual circumstances that gave rise to the expenditure in the leading authority, *Illinois Merchants Trust Co.* In that case, owing to an unprecedented lowering of the water level, the ends of some of the piles on which petitioner's building rested were exposed to the action of air. This resulted in dry rot. Although this *circumstance* may have been extraordinary in the experience of the taxpayer, it did what would be *ordinarily* expected under such circumstances. Namely, it caused the rotted piles to be sawed off at a point below the new water level and concrete supports to be inserted between the ends of the submerged piles and the floor of the building.

In *Midland Empire Packing Company*, 14 T.C. 635, (A) 1950 C.B. 3, petitioner, a meat packing corporation, was compelled to line the walls and floors of its basement with concrete to protect it from the seepage of oil spilled on the ground by a neighboring refinery, because the oil nuisance threatened continued operation of the packing plant. Following the expenditures, the plant did not operate on any changed or larger scale, nor was it thereafter suitable for new or additional uses. The Tax Court, following *American Bemberg*, allowed the expenditure to be deducted because it served only to permit the continued use of the plant for its normal operations.

In *J. H. Collingwood et al.*, 20 T.C. 937, (A) 1954-1 C.B. 4, Explained, Rev. Rul. 54-191, 1954-1 C.B. 68, petitioner had owned and operated farms for many years and sought to check and reduce water erosion and loss of top soil by terracing his farms in accordance with approved specifications. Terraces were made by pushing the earth into ridges following the contours of the land. Nothing new was added to the farms. The purpose was not to change the use of the land, or to prepare it for use, or for new and additional uses, but was to maintain the productivity of the farms in normal and customary operation. The Tax Court following *American Bemberg* allowed these expenditures as essentially for maintenance and conservation rather than as permanent improvements.

In *Phillips & Easton Supply Company*, 20 T.C. 455, 459, the petitioner sought to apply the *American Bemberg* principle to the facts involved there. However, the Tax Court distinguished that case from the *American Bemberg* case on the ground that the evidence on the whole showed that the taxpayer had replaced a 46-year-old floor with a stronger floor designed to meet an expansion of business, including the handling of heavy goods and equipment, which the old floor could not support. Furthermore, the cost of the building including the floor had been fully recovered through depreciation allowance

5. How Does the Frequency of Repairs Affect the Deduction?

Usually it is impracticable and uneconomical to maintain property made up of hundreds or thousands of items by apportioning such maintenance annually over each item of property. Repairs, upkeep, or maintenance, as a practical matter, must be conducted on a rotating basis as necessity requires. Current maintenance may thus affect certain items a number of times each year, whereas many other items may require maintenance attention only once in a period of several years. This may result in violent fluctuations in annual maintenance charges. (See footnote 15.)

The fact that certain equipment may need repairs only at intervals of several years will not render such repairs when made in the nature of rehabilitation. Notwithstanding the fact that true repairs to such property need not be made annually in order to keep the property in a reasonable efficient operating condition, it does not necessarily follow that such repairs, when made, are not currently deductible. Thus, the fact that, as the result of improvements effected by certain repairs, the property may go several years without need of further repairs, does not necessarily prevent the current deduction of the expenditures therefor when paid or incurred.[21] For example, this principle of prolonged survival of the effect of repairs is probably best illustrated in *Kansas City Southern Railway Company* v. *United States,*[22] 112 Fed. Supp. 164, followed in Rev. Rul. 54-356, 1954-2 C.B. 82. There the repair consisted of driving poles to eliminate water pockets which had become a hazard to economical train speeds. The beneficial effect of these expenditures, it was thought, would continue for some fifteen years. However, the Court of Claims held such cost was a mere maintenance cost and, as the Court so aptly said, "the railroad track, after the poles were driven, was still a railroad track, and the parts of it where the poles were driven were no more useful than the other parts which had not needed this work." Similar difficulties may arise at other points along the track. Proper maintenance requires their treatment, wherever and as often as they occur. Nor does the fact that repairs may correct defects that have been accumulating for several years render the expenditure a capital item.[23] In the last analysis, without these expenditures the property could not have been *maintained* in the condition requisite to its normal use.

The Court pointed out that if at the time of the construction of the railroad it had been possible to see where the water pockets would appear, and if poles had then been driven, their cost, of course, would have been a capital cost. When, however, in particular locations, water pockets develop and casually appear, they present a problem of maintaining an existing completed track in a safe and economical condition, the cost of which becomes deductible maintenance. Periodical painting is in no different category. The original paint job, of course, is part of the capital cost, but subsequent painting, even though its beneficial effect may extend several years, is nevertheless deductible maintenance.

6. How to Get Deductions for Repairs Made Simultaneously with Improvements

Repairs are sometimes made in connection with a general program of improvements. In such cases great care should be exercised that invoices and other supporting data are preserved. These documents should clearly distinguish between the amounts spent for repairs and those spent for improvements. This is perhaps one of the most vulnerable spots in the matter of getting the maximum deductions for repairs. Although it is not always practicable or economical to forego the making of repairs that belong to an essentially current maintenance classification during the course of a program of improvement affecting the same property, it frequently happens that the internal revenue agent will lump essentially maintenance items with the general improvement items and insist upon capitalizing the whole. Therefore, wherever it is feasible and economical to do so, current maintenance repairs should not be undertaken during the course of such a program of general improvement. Sometimes this is impossible, as is illustrated in *Universal Mills.*[24] There the taxpayer had paid a contractor for repairing, water proofing, and painting concrete grain elevators, which had developed cracks. The Tax Court found half of the expenditure to be deductible as representing the cost of repairing the cracks and painting. The water proofing, the Tax Court believed, improved the property itself, giving the petitioner something that it had not had before.

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[21] *Buckland* v. *U.S.*, 66 F. Supp. 681 (1946), 35 AFTR 161.

[22] *Kansas City Southern Railway Co.* v. *the United States*, 112 F. Supp. 164.

[23] See footnote 21, above.

7. When Is the Life of an Asset Prolonged?

It has been shown that the magnitude of the cost of the repair will not necessarily make it a non-deductible replacement[25] unless the extent of the repair has the effect of substantially prolonging the life of the property. The determination of whether the life of the property has been substantially prolonged by the repair is essentially one of fact. However, the legal question of whether the "life of the property" should be assumed to be the life indicated by past depreciation deductions or by some other test or proof appears not to have been expressly decided.

The case of *P. Dougherty Co.*[26] probably involved various shades of all these questions. The property involved there was a barge, the entire cost of which had been recovered by depreciation allowances in prior taxable years. During 1943, $17,500 was spent in rebuilding the stern of the barge, whose rotted timbers and planks had to be torn out and replaced. The Court of Appeals for the Fourth Circuit affirmed the Tax Court's determination that the rebuilding of the stern of the barge was in the nature of a permanent betterment to be capitalized and not to be deducted as an expense.

Two factors probably combined to influence the capitalizing rather than the expensing of this repair: (a) It was a major repair, thus involving some factor of degree and (b) the barge had been completely written off by depreciation allowances, indicating that the vessel was made to outlive its normal life expectancy as a result of the repair. The result might have been different had the taxpayer in the past used a normal depreciation rate in the place of an obviously excessive rate in depreciating the vessel. There was certainly lacking a proper measure of the normal life of the vessel to serve as an indication of whether or not the repair actually did prolong its life beyond its normal expectancy.

Obviously a repair that materially adds to the value of the property or appreciably prolongs its life is not a current expense. Deductible repairs are thus tied in with depreciation. In this regard, it would seem that a test of deductibility in the case of repairs is indicated in the definition of depreciation by the Supreme Court in *Lindheimer, et al., Commissioners* v. *Illinois Bell Telephone Co.*[27] In that case the Supreme Court defined the word "depreciation" as follows:

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[24] T.C. Memo. 11-26-48.

[25] *Buckland* v. *U.S.* 66 F. Supp. 681 (1946), 35 AFTR 161.

[26] 5 T.C. 791 (1945), affirmed (4 Cir. 1947) 159 F. 2d 269.

> Broadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy, and obsolescence. Annual depreciation is the loss which takes place in a year.

"Current maintenance" includes current repairs and servicing such as cleaning, oiling, adjusting, inspecting and other expenditures incidental to current upkeep, including the renewal of "minor" items.

Section 263(a)(2) forbids the deduction of: "Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made."

The foregoing provision was only intended to prevent double deductions.[28] This thought is emphasized when it is realized that depreciation is the loss due to exhaustion and wear and tear not made good by current maintenance.

It should be borne in mind that merely because a court has ruled certain deductions for repairs to be not allowable, it does not always follow that the Commissioner will continue to insist upon the application of the supposed principle so decided.

In *Buffalo Union Furnace Co.*[29] the taxpayer was refused the right to deduct a reserve for relining its blast furnaces on the ground that it was precautionary or contingent. Notwithstanding this decision, at the present day the Commissioner will allow a reasonable reserve for relining blast furnaces where the taxpayer consistently follows such method of accounting.[30] (See comments contained in footnote 15.)

8. What Is the Exception to the General Rule on Repairs?

There is at least one exception to the foregoing principles that must also be taken into consideration. Expenditures for mine cars and rails and the like may be deducted, provided such expenditures do not add to the value of the property and are not made for the purpose of increasing production or decreasing the cost of operation. Although this special rule has been long settled by abundant authority, it is contrary to the general rule that machinery with a life longer than a year is to be capitalized and depreciated. Stated affirmatively, this special rule applicable to mining and gas and oil producing properties is that: All expenditure for plant and equipment necessary to bring the property to capacity is properly a capital charge while all expenditures for additions, renewals and extensions necessary to maintain output should be charged to operation.[31]

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[27] 292 U.S. 151, 167 (1934).

[28] See *Hubinger* v. *Commissioner* (2 Cir. 1930), 36 F. 2d 724, 8 AFTR 9906.

[29] (2 Cir. 1934) 72 F. 2d 399.

[30] See Bulletin "F," January 1942, pages 42, 43, where blast furnaces are given a life of 25 years and blast furnace linings, a life of four years.

[31] See *Benedict Coal Corporation*, T.C. Memo., July 20, 1943, par. 43,357 Prentice-Hall Memorandum T.C. *U.S.* v. *Roden Coal Company* (5 Cir. 1930). 39 F. 2d 425, 8 AFTR 10528; *Marsh Fork Coal Co.* v. *Lucas* (4 Cir. 1930) 42 F. 2d 83, 8 AFTR 11046; *Guanacevi Mining Co.* v. *Commissioner* (9 Cir. 1942) 127 F. 2d 49, 29 AFTR 66.

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29

How to Get Maximum Deductions for Depreciation

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The 1954 Code has made important changes in the depreciation methods that are available to taxpayers for certain new property.[1] These changes and the new administrative policy recently promulgated by the Internal Revenue Service in regard to minor adjustments of depreciation deductions are designed to liberalize depreciation allowances and eliminate a frequent source of irritation. It is probable that material benefits will be realized by taxpayers as the result of these changes. One should bear in mind, however, that they have produced no panacea and that fundamental depreciation principles must still be observed and followed if the most desirable depreciation allowances are to be obtained.

Before considering basic principles, it is well to review briefly the significant statutory and administrative changes that have recently been made. This will serve as a useful background against which to examine these principles.

First, as to Section 167 of the 1954 Code, a summary of its important provisions as published by the Treasury Department in its introduction to the tentative regulations applicable to that section reads as follows:[2]

> It provides for the use of the declining balance method at a rate not in excess of 200 per cent of the corresponding straight-line rate, the sum of the years-digits method, or equivalent methods which at the end of each year during the first two-thirds of the life of the property result in accumulated allowances not in excess of those under the declining balance method. It grants taxpayers the option to switch from the declining balance method to straight-line depreciation at any time on the basis of unrecovered cost less estimated salvage and estimated remaining life at the time of the switch. The liberalized depreciation methods apply only to property with a useful life of three years or more which is acquired after December 31, 1953, if the original use of the property commences with the taxpayer and commences after that date or the property is constructed, reconstructed, or erected after December 31, 1953, and then only to the portion of the basis of such property attributable to construction, reconstruction, or erection after December 31, 1953. It permits agreements in writing with respect to depreciation rates which will then stand in the absence of facts or circumstances not taken into consideration in arriving at such agreements with the burden of proof on the party initiating any change to establish the existence of such facts and circumstances. The changes are to be prospective only.

It is apparent that the principal change effected by the 1954 Code is the liberalizing of the depreciation allowance on new assets by concentrating deductions in the early years of service. An analysis will subsequently be made of the methods by which such increased allowances may be obtained.

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[1] 1954 IRC Sec. 167.

[2] Federal Register, Sept. 25, 1954.

Second, more than a year before the new Code was enacted, the Internal Revenue Service published and placed in operation a statement of general policy toward depreciation deductions and a guide to members of the Service in carrying out that policy.[3] In these bulletins, the Service announced that it proposes in the future not to disturb depreciation deductions taken by a taxpayer unless "there is a clear and convincing basis for a change." The taxpayer's estimate of the useful life of his assets will probably be allowed to stand despite the fact that it may be excessive unless the Service regards the variance as substantial.[4] Time and experience with this administrative policy will tell how large a margin of error the Service will usually allow. It is too early to judge its practical effects but, if there is no widespread abuse of the procedure, it should eliminate many of the minor problems and reduce the amount of controversy with taxpayers over the question of depreciation.

Third, an amendment recently made to the 1939 Code[5] and carried over to the new Code[6] eliminated another source of litigation. Section 113(b)(1)(B) formerly contained the controversial provision that the basis of assets must be reduced by the amount of depreciation "to the extent allowed (but not less than the amount allowable)" in any taxable year. The Supreme Court interpreted this language to mean that any amount reported as a deduction for depreciation in a tax return and not challenged by the Bureau was "allowed" even though it was admittedly erroneous and no tax benefit was realized thereby.[7] The basis of the assets was required to be reduced by the amount of any such incorrect deduction in excess of what was allowable. The amendment to the Code has eliminated this source of dissatisfaction by providing that basis shall be reduced by the amount of depreciation allowed as a deduction in computing net income and resulting in a reduction of taxes. If, therefore, the depreciation reported is greater than the amount that is allowable, basis shall be reduced by the erroneous excess only to the extent that the deduction results in a tax benefit.

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[3] IR-MIM. No. 183, 5/11/53, states the general policy and IR-CIRCULAR No. 144, 5/11/53, sets forth the factors which are intended to serve as a guide to the Internal Revenue Service in order to give full force and effect to that policy. These factors are: "(a) Whether depreciation rates used by the taxpayer are fair and reasonable under the circumstances; (b) Whether the taxpayer has followed a consistent practice in arriving at the amount of depreciation deductions; (c) Whether in considering all factors, including reasonable tolerances, any adjustments proposed are substantial."

[4] H.R. 8300, 83rd Congress, 2nd Session, originally proposed in Sec. 167 that the new Code fix at 10 per cent the permissible difference between the Commissioner's and the taxpayer's estimate of the appropriate useful life of property. That provision was eliminated from the final bill because, as the Senate Finance Committee stated in the General Explanation, it "would be considered inadequate and unsatisfactory by some taxpayers, and might be a substantial source of misunderstanding and distortion." Sen. Rep. No. 1622, 83rd Cong., 2nd Sess., p. 28.

[5] 1939 IRC Sec. 113(b)(1)(B), amended by Public Law 539, 82d Congress, 2d Session. The tax-benefit rule applies for all periods after December 31, 1938. However, for any period after February 28, 1913 and before January 1, 1952, a taxpayer was required under Sec. 113(b)(1)(D), added by the said law, to exercise an election as to all property held during that period that the tax-benefit rule apply. As originally amended by said law no such election could be made after December 31, 1952, but a further amendment by Sec. 102(a), Technical Changes Act of 1953, extended the time to December 31, 1954. An election when once made is irrevocable, except that an election exercised on or before December 31, 1952 pursuant to the previous amendment could be revoked at any time before January 1, 1955.

[6] 1954 IRC Sec. 1016(a)(2)(B) and Sec. 1020.

[7] *Virginian Hotel Corporation* v. *Helvering,* 319 U.S. 523, 63 Sup. Ct. 1260, 30 AFTR 1304 (1943).

The main problems relating to depreciation deductions have not, however, been solved by these changes. It is the purpose of this chapter to analyze the problems that are inherent in the depreciation allowance. The principal factors, of course, are the taxpayer's basis and the rate of depreciation, but numerous other phases of the subject can become controversial if treated inadequately at their inception.

1. Points to Consider

A careful study of your depreciation problem requires that you review the following basic subjects:

	Section
What is the function of the depreciation allowance?	2
Who is entitled to depreciation?	3
What assets are depreciable?	4
What is your basis for depreciation?	5
What depreciation method shall you employ?	7
What are the factors in determining the rate of depreciation or useful life of your assets?	9-11

It is apparent that the first practical issue is whether your interest in the asset entitles you to any depreciation. This involves consideration of the following questions:

	Section
Have you made any investment or incurred any cost in acquiring the asset?	3
Are you a donee, a trustee, an executor or a beneficiary?	3
What are the respective rights of lessor and lessee?	3
Was the asset acquired under a lease-purchase agreement?	3

The determination of a taxpayer's proper basis for computing depreciation is a frequent cause of litigation with the Commissioner. This phase of the subject requires attention to the following matters:

	Section
What is your cost?	5
What items are includible in the determination of cost?	5
Have you carefully distinguished between capital expenditures for additions, replacements, and improvements and ordinary expenses for repairs?	6(1), 6(6)
Was your property acquired in a foreclosure proceeding?	5
Did you acquire the property by gift, inheritance or devise?	5
Were you involved in a reorganization proceeding?	5
Is it necessary to allocate your cost among several units?	5(8)
How and when shall adjustment be made for errors or changes in salvage value?	6(3)
Was your property converted from a residence to a business?	5(6)
Is your basis affected by an exclusion from gross income due to a discharge from indebtedness?	6(4)

	Section
Have you had any involuntary conversions of property?	5
Have you had any losses or retirements that affected the basis of your assets?	6(1)

After the cost basis of your assets has been determined, your next problem is the choice of a depreciation method. It involves the following questions:

	Section
Should you adopt the straight-line method, declining balance method, sum of the years-digits method, or some other method?	8
Shall you use item accounts or classified, group or composite accounts?	8

The final, most complex phase of the entire depreciation problem is, of course, the estimation of the rate of depreciation or useful life of the assets. This calls for a very careful study and application of the apposite principles of depreciation since it affects the tax liabilities of almost every taxpayer or business and its rules are often employed to the great disadvantage of taxpayers. Essential questions to consider in regard to this subject are:

	Section
What factors are material in determining useful life?	9
What part does obsolescence play?	9, 10
How and when should you adjust for errors or changes in the obsolescence factor or in the estimate of useful life?	12(2)
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2. The Theory of Depreciation

The object of depreciation is to enable the taxpayer to recover, through allowable deductions from gross income, the amounts which he has invested (or which otherwise constitute his cost basis) in physical equipment acquired for the production of income.[8] From an accounting as well as an economic viewpoint it is considered that plant and equipment are used up in the production of goods[9] and, therefore, the ratable portion of their cost that is expended annually ought to be reflected in the cost of operations.[10] In theory, the depreciation deduction provides by means of such annual allowances an aggregate sum that (in addition to any remaining salvage value) will restore a capital investment tax-free.[11]

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[8] Reg. 144, Sec. 29.113(b)(1)-1; *X-Pando Corporation*, 7 T.C. 48 (1946); *C. L. Downey*, 10 T.C. 837 (1948), affirmed (8 Cir. 1949), 172 F. 2d 810.

[9] *U.S.* v. *Ludey*, 274 U.S. 295, 47 Sup. Ct. 608, 6 AFTR 6754 (1927). The classic analysis of the depreciation allowance made by Mr. Justice Brandeis in this case, and which has been quoted in numerous decisions, reads as follows:

"The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it. The depreciation charge is the measure of the cost of the part which has been sold."

In determining the annual depreciation allowance, the 1954 Code has shifted the emphasis from ratable physical exhaustion of property to reduction in monetary value. It has provided for accelerated depreciation in the early years as a stimulus to investment in plant and equipment. In amending the law Congress has said that the new liberalized allowances are "more in accord with the actual pattern of loss of economic usefulness," [12] but so great are the allowable deductions in the first few years that their ratio to cost will in most cases exceed the percentage of actual physical wear and tear, inclusive of obsolescence.

Note that Congress does not assure a taxpayer of the recovery of his capital investment.[13] The Code merely provides for tax allowances for depreciation through deductions from gross income.[14] A depreciation deduction that creates no tax benefit in a year of insufficient income cannot be stored for use in a subsequent year.[15] Consequently, the portion of the capital investment that might have been recovered in such a year is irretrievably lost, except through the possible application of carry-back and carry-over losses.

The basis of assets under the Code must be reduced by the amount of the allowable depreciation in each taxable year even though the deduction results in no tax benefit. If the amount reported is greater than the allowable depreciation, then if no tax benefit is realized by reason of the deduction the erroneous excess may be restored to basis.[16] A taxpayer claiming the right to such restoration will have the burden of proving the correct allowable depreciation in the taxable years involved and that the excess amount reported did not result in a reduction of taxes.

For these reasons it is of the utmost importance that you endeavor to adopt a program that will give you the fullest benefit of the depreciation deduction—that is, recover as much of your invested capital or basis as the law allows during the years when recovery is allowable To accomplish this you must:

(a) Take depreciation on all assets upon which you are entitled to depreciation;

(b) Adopt the depreciation method most suitable to your type of operation and the character of your assets;

(c) Include in your basis the full amount of your cost or adjusted basis, and no more;

(d) Adjust your basis regularly during the years when adjustments are required;

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[10] *Even Realty Co.* 1 B.T.A. 355 (1925), a landmark in the field of depreciation cited with approval in *U.S.* v. *Ludey*, footnote 9 above, and in a great many cases since then.

[11] *U.S.* v. *Ludey*, footnote 9 above; *C. L. Downey*, footnote 8 above; Reg. 118, Sec. 39.23(1)-1.

[12] H.R. Report No. 1337, 83rd Congress, 2nd Session, IX G. The Proposed Regulations (Sec. 1.167(a)-1) state, however, that the "allowance will not include amounts representing a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence."

[13] *Virginian Hotel Corporation* v. *Helvering*, footnote 7, above.

[14] 1939 IRC Sec. 23(1); 1954 IRC Sec. 167(a).

[15] *U.S. Industrial Alcohol Co.* v. *Helvering* (2 Cir. 1943), 137 F. 2d 511, 31 AFTR 425; *Hardwick Realty Co.* v. *Commissioner* (2 Cir. 1928), 29 F. 2d 498, 7 AFTR 8320; *P. Dougherty Co.* v. *Commissioner* (4 Cir. 1946), 159 F. 2d 269, 35 AFTR 669; *Virginian Hotel Corporation* v. *Helvering*, Footnote 7 above; Reg. 118, Sec. 39.23(1)-5.

[16] See footnote 5, above.

(e) Have the rates of depreciation or useful lives of your assets determined as expertly as possible;

(f) Adjust your depreciation rates regularly during the years when adjustments should be made.

3. Are You Entitled to Depreciation?

Generally, a taxpayer has an interest which entitles him to depreciation when he has made an investment in a property.[17] Mere ownership or legal title does not necessarily warrant a depreciation deduction.[18] A vendee under a conditional bill of sale or executory contract for the sale of property acquires the right to depreciation from the time he enters into possession and assumes the burdens and benefits of ownership. Under the 1939 Code, property, or the funds with which to acquire property, received from a municipality or chamber of commerce as an inducement to transfer establishment of a plant, is deemed to be a contribution to surplus and, therefore, the recipient is entitled to the depreciation thereon.[19] The 1954 Code has changed the rule to provide that the cost basis of property acquired as a contribution to capital after June 22, 1954 or purchased, within twelve months, with cash received as a contribution from one who is not a stockholder shall be zero.[20] A cost or capital outlay must be incurred by a taxpayer to warrant a deduction, except in the cases of donees, executors, trustees, and persons generally who acquire property from a decedent or to whom property is deemed to have passed from a decedent. Under the Code,[21] this latter group of taxpayers, having succeeded to an owner's beneficial interest in property, has been expressly allowed the depreciation deduction computed according to the respective adjusted basis of the property defined in each instance.[22] If property is held by a life tenant, the deduction is allowed to him as though he were the owner; in the case of property held in trust, it is apportioned among the income beneficiaries and trustee according to the terms of the instrument creating the trust or, in the absence of any such provisions, on the basis of the trust income allowable to each.[23]

A lessee who makes improvements to leased property is entitled to recover the amount of his cost or investment in such improvements through allowable depreciation deductions.[24] The lessor, on the other hand, cannot take a deduction therefor, since he has incurred no cost.[25] When a lessor joins in a venture and contributes toward the cost of a lessee's improvement, however, each party is entitled to depreciation to the extent of his respective capital investment.[26] The same result follows, of course, when a lessee pays a lump sum to his lessor as a contribution toward an improvement to a leased property made by the lessor.

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[17] *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 30 AFTR 1096 (1943); *Moore* v. *Commissioner* (9 Cir. 1953), 207 F. 2d 265, cert. den. 4/12/54.

[18] I.T. 2275, VI-1 C.B. 62; I.T. 2025, III-1 C.B. 166; *E. J. Murray*, 21 T.C. 1049, 1062 (1954).

[19] *Brown Shoe Co., Inc.* v. *Commissioner*, 339 U.S. 583 (1950).

[20] 1954 IRC Sec. 362(c).

[21] As to gifts or transfers in trust before January 1, 1921, 1939 IRC Sec. 113(a)(4), 1954 IRC Sec. 1015(c); as to gifts after December 30, 1920, 1939 IRC Sec. 113(a)(2), 1954 IRC Sec. 1015(a); as to property that passes from a decedent, 1939 IRC Sec. 113(a)(5), 1954 IRC Sec. 1014; as to life tenants, remaindermen, trustees and beneficiaries of trusts, 1939 IRC Sec. 23(1)(2), Reg. 118, Sec. 39.23(1)-1; 1954 IRC Sec. 167(g). But see *Kathryn T. MacMurray*, 16 T.C. 616 (1951) in which it was held that under 1939 IRC Sec. 23(1)(2) the beneficiary of a testamentary trust is not entitled to depreciation until the trust has been set up following completion of administration. 1954 IRC Sec. 167(g) also corrects an omission in regard to estates by providing for apportionment of the depreciation allowance amongst the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

[22] See Sec. 5 of this chapter for discussion as to their basis.

[23] Careful consideration should be given to this phase of the depreciation problem in the preparation of inter vivos and testamentary trusts. Trust instruments rarely mention the subject of the depreciation allowance. As a result, no reserve for depreciation of property is set up for remaindermen, even in cases where their welfare is of greater concern to the trustor than is that of the life tenant or income-beneficiary.

Caution should be exercised in regard to property acquired or held under so-called "lease-purchase" agreements. Contracts for the sale of real or personal property frequently describe the purchaser as lessee and the periodic payments as rent. This generally occurs where the lessee has an option to buy[27] or where title will pass to him automatically at the expiration of a specified term[28] or upon the payment of an aggregate sum.[29] Recitals in a lease or sales agreement as to the denomination of the parties or the character of the consideration paid are not decisive. Whether the designated lessee is actually a purchaser, with a depreciable interest in the asset, will depend upon the true nature of the contract. It is important, therefore, that you examine such contracts to determine whether your real interest is that of owner or lessee—the allowable depreciation deduction is likely to differ from the amount specified in the instrument as annual rental.

The significance of the injunction to determine with care whether or not one has a depreciable interest in a property cannot be overemphasized. As this chapter has already pointed out, the basis of property is reduced by the amount of depreciation allowable in each taxable period, whether it is reported or not. Failure to recognize that your interest is depreciable may mean, therefore, a wasting of your capital investment.

4. What Assets Are Depreciable?

Depreciation is allowable on assets which meet the following requirements:

(a) The property must be held for use in your trade or business (provided that it is not a part of your inventory or stock in trade) or for the production of income.[30] A private residence, a boat, a private automobile or a similar property held solely for personal as distinguished from business use is not the subject of a depreciation allowance unless and until it is appropriated to income-producing purposes.[31] When property held for personal use and enjoyment is converted to the production of income, the evidence of such a conversion should be unequivocal. It is desirable that in the year of its occurrence you assemble evidence of listing the property for rent with a broker, advertising in newspapers or periodicals, efforts of agents to interest prospective tenants or lessees in the property, etc. Do not wait until your tax return is under examination to gather proof in support of the deduction.

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[24] *Helvering* v. *F. & R. Lazarus*, 308 U.S. 252, 23 AFTR 778 (1939); Reg. 118, Sec. 39.23(a)-10. For a discussion respecting the period over which the cost of such improvements shall be amortized by the lessee see Sec. 13 of this article.

[25] *Commissioner* v. *Moore*, footnote 17, above; *Albert L. Rowan*, 22 T.C. 865 (1954); *Frieda Bernstein*, 22 T.C. 1146 (1954). The Tax Court now holds that a taxpayer who inherits property on which a building was constructed by the lessee at no cost to the lessor is not entitled to depreciation; but the taxpayer may be entitled to amortization of any "premium value" attributable to favorable rentals contained in the lease.

[26] *Commissioner* v. *Revere Land Company* (3 Cir. 1948), 169 F. 2d 469, cert. den. 69 Sup. Ct. 82. The Circuit Court stresses the point that a mere contribution "independent of any other circumstances, undertakings or conditions" does not give one an investment status warranting a depreciable interest in the property. The intention of the parties must be that the contributor acquire an investment status. It is noteworthy that in the cited cases an important evidentiary factor tended to refute the lessor's contention that its "contribution" constituted an investment in the project. It appears that the lessor's subsidiary received preferred stock of the lessee corporation for the full amount of the "contribution." The lessor's capital was, therefore, invested in the stock of the lessee corporation, not in the building erected on the lessor's land.

[27] *Judson Mills*, 11 T.C. 25 (1948); *Breece Veneer and Panel Company*, 22 T.C. 1386 (1954).

[28] *Helser Machine and Marine Works, Inc.*, 39 B.T.A. 644 (1939); *Holeproof Hosiery Co.*, 11 B.T.A. 547 (1928); *Alexander W. Smith, Jr., Exec.*, 20 B.T.A. (1930).

[29] *Watson* v. *Commissioner* (9 Cir. 1932), 62 F. 2d 35, 11 AFTR 1051; *Truman Bowen*, 12 T.C. 446 (1949); *Chicago Stoker Corporation*, 14 T.C. 441 (1950).

Property held for personal use and enjoyment may, however, be partially devoted to business purposes. For example, part of a residence may serve as a business office or house a professional library for study and conference work. In such an instance you are entitled to depreciation on the portion of your home, furnishings, and equipment that is exclusively employed for this purpose.[32] The casual use of a residence or other assets in this manner will not warrant a deduction;[33] when the use is substantial an allocation of the depreciation allowance should be made based upon a reasonable estimate of the ratio of business use to the total use of the property. A diary, time record, expense book or other written record should be maintained as evidence of the character and extent of the use for business of otherwise non-business property.

(b) The property must be the kind which exhausts itself and becomes less valuable with use. If neither its physical life nor its investment are consumed, an asset cannot be said to depreciate.[34] Works of art, for example, not only do not customarily wear out; often their value increases with age. Land *per se* is not a depreciable asset, but if it can be shown that grading, drains, roadbeds, dams and similar improvements to land will deteriorate in a slow, continuous process, a cost basis may be recovered through annual depreciation allowances.[35]

(c) The useful life of the property must be capable of reasonably certain estimation. Absolute certainty is not required.[36] If your investment is to be recovered ratably over the useful life of the asset, it is apparent that one must be able to determine what that life is. On the other hand, *if the asset has no determinable life,* depreciation is not allowable.[37]

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[30] 1954 IRC Sec. 167(a); 1939 IRC Sec. 23(1); Reg. 118, Sec. 39.23(1)-2; Rev. Rule 108.

[31] *Mary Laughlin Robinson*, 2 T.C. 305 (1943); *Helen D. Emmet*, 11 T.C. 90 (1948). Since the amendment to 1939 IRC Sec. 23(a) by the Revenue Act of 1942, allowing deduction for non-trade or non-business expenses, it is no longer essential that residential property be actually rented in order to establish the conversion to business but it must be shown that the property was listed for rent and therefore held for the production of income. There must be "some unmistakable act of conversion or appropriation." Listing the property for sale rather than for rent is not such a conversion. Warren Leslie, Sr., 6 T.C. 488 (1946).

[32] *Arthur A. Beaudry*, T.C. Memo. Dec., Dkt. 109352 (1943), par. 43.156 Prentice-Hall Memorandum T.C.; affirmed on this point (2 Cir. 1945), 150 F. 2d 20, 33 AFTR 1945.

[33] *A. R. Calvelli*, 43 B.T.A. 6 (1940); Rev. Rul. 80: 1953-11.

[34] *X-Pando Corporation*, 7 T.C. 48 (1946); A.R.R. 4530, II-2 C.B. 145; G.C.M. 9357, X-1 C.B. 385.

[35] *Texas and Pacific Railway Company*, T.C.M. Dec. Dkt. 105730 (1943); *Clinton Cotton Mills Inc.* v. *Commissioner* (4 Cir. 1935), 78 F. 2d 292, 16 AFTR 380; *J. H. Collingwood*, 20 T.C. 937 (1953); Rev. Rul. 54-191, IRB 1954-22. See also 1954 IRC Sec. 175 which allows deduction of expenses for soil or water conservation or prevention of erosion of land used in farming.

[36] *Union Electric Company of Missouri*, 10 T.C. 802 (1948), affirmed (8 Cir. 1949) 177 F. 2d 269; *Pohlen* v. *Commissioner* (5 Cir. 1948), 165 F. 2d 258, 36 AFTR 520; *Helen D. Emmet*, 11 T.C. 90 (1948); I.T. 3873, C.B. 1947-2, page 82.

(d) You must be able to prove that the property carries a cost basis in your hands and what the amount of that basis is. Since the purpose of depreciation is to restore your capital investment tax-free, you have the burden of establishing the amount of that investment in depreciable assets.[38]

(e) It is immaterial that property held for use in a trade or business is idle. An asset which is otherwise depreciable does not lose that status while inactive[39] (except in the case of a personal holding company[40]); but no depreciation is allowable on property that has been abandoned since the remaining unrecovered cost is a loss in the year of the abandonment.[41]

5. What Is the Basis of Your Assets?

As a general rule, your basis consists of your investment in the asset less the estimated salvage value at the end of its useful life.[42] The problem of determining basis is simple where you purchase the asset for a sum of money, whether payable in cash, on terms, or under a conditional bill of sale.[43] The price represents your cost, and it is your cost (less the salvage value) that represents your depreciable base. Exceptions exist, however, when assets are acquired other than by purchase, are received in an exchange, or are otherwise affected by transactions reflecting upon the amount of your investment. Such situations and the resulting basis in each case are, in the main, as follows:

If the Property Is Acquired	*The Basis Is*
In a reorganization	The transferor's basis, increased by the amount of gain or decreased by the amount of loss recognized to the transferor.[44]
In a wholly or partially tax-free exchange generally	The basis of the property which you give in the exchange, decreased by the amount of any

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[37] Reg. 118, Sec. 39.23(1)-2.

[38] The J. E. Mergott Co., 11 T.C. 47 (1948); *Detroit Edison Co.* v. *Commissioner*, footnote 17 above.

[39] *P. Dougherty Co.* v. *Commissioner*, footnote 15, above; *Hardwicke Realty Co.* v. *Commissioner* (2 Cir. 1928), 29 F. 2d 498, 7 AFTR 8320; *Kittredge* v. *Commissioner* (2 Cir. 1937), 88 F. 2d 632, 19 AFTR 177.

[40] 1939 IRC Sec. 505(b); 1954 IRC Sec. 545(b)(8); *Wilson Bros. & Co.* v. *Commissioner* (9 Cir. 1948), 170 F. 2d 423, cert. den. 69 Sup. Ct. 514.

[41] *Alexander Brothers Lumber Company*, 22 B.T.A. 153 (1931); 1939 IRC Sec. 23(e); Reg. 118, Sec. 39.23(e)-3; 1954 IRC Sec. 165(a) and (c); W. B. *Davis & Son, Inc.*, 5 T.C. 1195, 1218 (1945).

[42] 1939 IRC Secs. 114(a), 113(a); 1954 IRC Secs. 167(f), 1011, 1012; *U.S.* v. *Ludey*, footnote 9 above. The proposed depreciation regulations (referred to throughout this chapter as Prop. Reg.) provide in Sec. 1.167(b)-1(b)(2) thereof that in the case of new property where the declining balance method is used, no adjustment is made for salvage. Bulletin F, page 7, states that salvage may serve to reduce the basis or to reduce the rate. It is generally treated as a reduction to basis. *Terminal Realty Corporation*, 32 B.T.A. 623 (1935); *Bolta Company*, T.C. Memo. Dec., November 28, 1945; par. 45,360 Prentice-Hall Memorandum T.C. References to Bulletin F in this chapter are to the edition revised January 1942.

[43] Footnote 18 above.

[44] See 1939 IRC Sec. 113(a)(7)(A) as to transfers to a corporation after December 31, 1917 and in a taxable year beginning before January 1, 1936; 1939 IRC Sec. 113(a)(7)(B) as to

If the Property Is Acquired	*The Basis Is*
	money you receive, and increased by the amount of gain or decreased by the amount of loss recognized to you in the exchange.[45]
In a taxable exchange	Your cost,[46] which in this instance is deemed to be the fair market value of the property received in the exchange.[47]
In a taxable exchange for stock	Your cost, which in this case is deemed to be the fair market value of the stock given in the exchange.[48]
As a distribution in kind in a taxable liquidation	The fair market value of the asset received at the time of the distribution.[49]
By a corporation upon the complete liquidation of a subsidiary pursuant to Section 112(b)(6) (1954 IRC Sec. 332)	The transferor's basis.[50]
By a corporation or individual stockholder as a taxable dividend	To an individual stockholder, the fair market value at the time of the distribution; but to a corporate stockholder, the lesser of fair market value or the adjusted basis of the property

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transfers to a corporation in a taxable year beginning after December 31, 1935; 1939 IRC Sec. 113(a)(8) as to property acquired after December 31, 1920 by the issuance of stock or as paid in surplus. Reg. 118, Sec. 39.113(a)(7)-1 and 39.111(a)(8)-1. *Montgomery Building Realty Company*, 7 T.C. 417 (1946); *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 28 AFTR 567 (1942); *Peabody Hotel Company*, 7 T.C. 600 (1946); *Richard H. Survaunt*, 5 T.C. 665 (1945). The rule is also applicable to property received in a reorganization in a bankruptcy, receivership, foreclosure or similar proceeding pursuant to 1939 IRC Secs. 112(b)(10), 113(a)(22). As to property acquired on or after June 22, 1954, see 1954 IRC Secs. 362(b), 358.

[45] 1939 IRC Sec. 113(a)(6); Reg. 118, Sec. 39.113(a)(6)-1; 1954 IRC Sec. 1031(d). To qualify under this section the transaction must involve an exchange of "substantially identical" properties and satisfy the requirements of 1939 IRC Sec. 112(b)(1), 1954 IRC Sec. 1031(a). *W. D. Haden Company* v. *Commissioner* (5 Cir. 1948), 165 F. 2d 588, 36 AFTR 670; *Thomas Watson*, 8 T.C. 569 (1947); Bulletin F, page 80.

[46] 1939 IRC Sec. 113(a); Reg. 118, Sec. 39.113(a)-2; 1954 IRC Sec. 1012.

[47] In a taxable exchange of properties, the transaction is treated as though the asset surrendered was sold for an amount equal to the fair market value of the asset received. Consequently, the basis of the asset received is its fair market value at the time of the exchange. Bulletin F, page 80; I.T. 3523, 1941-2 C.V., 124. Gain is recognized to the extent of the difference between the basis of the asset surrendered and the fair market value of the asset received. *Stevenson Consolidated Oil Co.*, 23 B.T.A. 610. However, if the property received has no fair market value or such value is not determinable, its basis is the fair market value of the asset given in exchange. *Pierce Oil Corporation*, 32 B.T.A. 403, 430 (1935).

[48] Where stock is issued for assets in a taxable exchange, the basis of the assets received is the fair market value of the stock, but if the stock has no fair market value, basis is the fair market value of the assets received. *Maltine Co.*, 5 T.C. 1265 (1945); *Amerex Holding Corporation*, 37 B.T.A. 1169, 1188 (1938); *Pierce Holding Corporation*, footnote 45, above; *Forstmann* v. *Rogers* (3 Cir. 1941) 128 F. 2d 126, 29 AFTR 475; *Hens & Kelly, Inc.*, 19 T.C. 305 (1952).

[49] *Texas Empire Pipe Line Co.*, 10 T.C. 140 (1948); *Peeler Hardware Company*, 5 T.C. 518, 523 (1945); *Gloyd* v. *Commissioner*, 63 F. 2d 649, 12 AFTR 259, cert. den. 290 U.S. 633 (1933). 1954 IRC Sec. 301(d)(1), Sec. 334(a). However, if an election were made by the stockholder pursuant to 1939 IRC Sec. 112(b)(7), 1954 IRC Sec. 333, basis would be the same as that of his cancelled shares decreased in the amount of any money received by him and increased in the amount of any gain recognized to him, plus the amount of any mortgage indebtedness outstanding against the property, whether the mortgage be assumed or whether it be taken subject. 1939 IRC Sec. 113(a)(18); Rev. Rul. 95; 1954 IRC Sec. 334(c).

[50] 1939 IRC Sec. 113(a)(15); Reg. 111, Sec. 29.113(a)(15)-1; 1954 IRC Sec. 334(b)(1). But see Sec. 334(b)(2) for rule where at least 80% of the stock of the distributing corporation is acquired by purchase by the distributee during a period of not more than 12 months.

If the Property Is Acquired	*The Basis Is*
	in the distributee's hands increased in the amount of gain recognized to the distributing corporation.[51]
By a corporation as paid-in surplus or as a contribution to capital	The transferor's basis, increased by the amount of gain or decreased by the amount of loss recognized to the transferor.[52]
By a corporation during affiliation	The same as in the hands of the corporation from which acquired.[53]
By a partnership as a contribution by a partner	The contributing partner's cost or other basis.[54]
By a partner upon liquidation of the partnership	Under 1939 IRC, that part of the basis of his partnership interest as the value at the time of distribution of each asset received by him bears to the total value of all the assets received by him.[55] As to taxable years beginning after December 31, 1954, see 1954 IRC Sec. 732.
Prior to March 1, 1913	The fair market value at March 1, 1913 or cost less depreciation "to the extent sustained"—whichever is higher.[56]
As a gift or transfer in trust before January 1, 1921	The fair market value at the time of the acquisition.[57]
As a gift after December 31, 1920	The donor's basis, except that if this is greater than the fair market value at the time of the gift, the basis for determining loss only is the fair market value.[58]
As a transfer in trust after December 31, 1920	The grantor's basis, increased by the amount of gain or decreased by the amount of loss recognized to the grantor.[59]
As a bequest, a devise, or an inheritance	Fair market value at the date of death, or at the optional valuation date if an option is exercised by the executor.[60]

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[51] 1954 IRC Sec. 301(d).

[52] 1939 IRC Sec. 113(a)(8); 1954 IRC Sec. 362(a).

[53] Reg. 104, Sec. 23.28, as amended by T.D. 5441, 1945 C.B. page 214; Reg. 118, Sec. 39.113(a)(11)-1; 1954 IRC Sec. 1051.

[54] 1939 IRC Sec. 113(a)(13); Reg. 118 Sec. 39.113(a)-1. By "cost or other basis" is meant the partner's basis, increased in the amount of gain, or decreased in the amount of loss recognized to him on the transfer. 1954 IRC Sec. 723.

[55] 1939 IRC Sec. 113(a)(13); Reg. 118, Sec. 39.113(a)-2; G.C.M. 20251, 1938-2 C.B. 169; I.T. 2010, III-1 C.B. 46; see *Commissioner* v. *Lehman* (2 Cir. 1948), 165 F. 2d 383, 36 AFTR 545. It should be noted that, as to taxable years ending on or before December 31, 1954, the basis of the partner's interest in the partnership is not simply his basis of the assets contributed by him; but it is that basis plus "the amount of his share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid" reduced by (1) his share of partnership losses, (2) any withdrawals made by him, and (3) any cash received by him on the liquidation.

[56] 1939 IRC Sec. 113(a)(14); 1939 IRC Sec. 113(b)(1)(C); 1954 IRC Sec. 1053.

[57] 1939 IRC Sec. 113(a)(4); 1954 IRC Sec. 1015(c).

[58] 1939 IRC Sec. 113(a)(2); 1954 IRC Sec. 1015(a).

[59] 1939 IRC Sec. 113(a)(3); 1954 IRC Sec. 1015(b).

[60] 1939 IRC Sec. 113(a)(5); 1954 IRC Sec. 1014; Reg. 118, Sec. 39.113(a)(5)-1; 1939 IRC Sec. 811(j); Reg. 105, Sec. 81.11. Where the executor exercises the election under 1939 IRC Sec. 811(j), 1954 IRC 2032, the valuation date is one year from date of decedent's death unless the property is sold or distributed within the year, in which event the valuation date is the date of

If the Property Is Acquired	*The Basis Is*
As the result of an involuntary conversion	The same as that of the property converted, decreased by the amount of money received but not expended for similar property, and increased by the amount of gain or decreased by the amount of loss recognized on the conversion.[61]
Subject to a mortgage	The cost, including the amount of the mortgage—not merely the "equity."[62]
By a mortgagee on the foreclosure of a mortgage	The fair market value of the property at the time of the foreclosure sale.[63]

As to the basis of property in certain special situations, the following points should be considered:

1. If the property was improved by a lessee at the lessee's cost prior to the decedent's death, neither the decedent's basis nor the basis of the property in the hands of his estate, his heirs, or his beneficiaries is increased thereby. The uncertainty which formerly existed in the law on this subject has since been resolved.[64] Unless the decedent made an investment in the improvement, he had no depreciable interest. By the same token where such property is inherited subject to the lease, the heirs or beneficiaries have no depreciable interest in the improvement.

2. Although the value of the property at date of death as reported in the estate tax return is presumptively its correct basis, it is not conclusive and in the absence of estoppel it may be rebutted.[65]

3. It is now settled law that where a corporation purchases the shares of another corporation in order to acquire its assets and promptly liquidates the predecessor, the basis of the predecessor's assets in the hands of the successor is the price paid by the latter corporation for the shares of stock and not a substituted

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the sale or distribution by the executor. This provision is applicable for the determination of basis only with respect to property includable in the gross estates of decedents dying after October 21, 1942. Where the executor or trustee purchases property however, the beneficiary or legatee takes over the cost basis of the executor or trustee. *Helvering* v. *Reynolds*, 61 Sup. Ct. 971 (1941). In the case of a beneficiary whose interest is contingent, his basis is nevertheless fair market value at date of death, but adjustment must be made to basis for depreciation since date of death. *George W. Carnick*, 9 T.C. 756 (1947). 1954 IRC Sec. 1014 now provides that as to decedents dying after December 31, 1954, basis is such fair market value in all cases including transfers in contemplation of death, tenancies by the entirety and tenancies in common with right of survivorship. If the transferee disposes of the property, however, prior to decedent's death, basis is the donor's basis or that of the last donor in the chain of title by whom the property was not acquired by gift. 1954 IRC Secs. 1014(a), 1015.

[61] 1939 IRC Sec. 113(a)(9); Reg. 118, Sec. 39.113(a)(9)-1; Reg. 118, Sec. 39.112(f)-1; 1954 IRC Sec. 1033(c).

[62] *Crane* v. *Commissioner*, 331 U.S. 1, 67 Sup. Ct. 1047, 35 AFTR 776 (1947); *Blackstone Theatre Co.*, 12 T.C. 801 (1949).

[63] Reg. 118, Sec. 39.23(k)-3. The price for which the property is bid in by the mortgagee is presumed to be the fair market value "in the absence of clear and convincing proof to the contrary." Note that the mortgagee at the foreclosure realizes gain or loss measured by the difference between his capital investment in the mortgage and such fair market value of the acquired property. This assumes, in the event of a loss, that any deficiency is uncollectible.

[64] See Footnote 25.

[65] *Northport Shores, Inc.*, 31 B.T.A. 1013 (1935); *Elizabeth G. Augustus*, 40 B.T.A. 1201 (1939).

basis.[66] This rule has been incorporated into the 1954 Code subject to specified restrictions.[67]

4. Where property has been held by a husband and wife as tenants by the entirety or by two or more persons as joint tenants with the right of survivorship, and all or part of the cost was paid by the decedent, the basis of the property, where the decedent has died on or before December 31, 1953, is its original cost and not the fair market value at the date of death, even if any part of that value was included in the decedent's estate for tax purposes.[68] As to decedents dying after December 31, 1953, basis in the case of such transfers is the fair market value of the property at date of death or the optional valuation death, as in the case of all property now acquired from a decedent.[69]

5. Prior to the 1954 Code, the basis of property received by a transfer in contemplation of death was the transferor's basis even though the market value of the property at date of death was included in the transferor's estate for tax purposes.[70] As to decedents dying after December 31, 1954, basis changes to market value.[71]

6. When assets are purchased or acquired by exchange, that part of their cost which represents good will is not amortizable; good will is not a wasting or depreciable asset.[72] On the other hand, if part of the purchase price was paid as a consideration for a covenant not to compete, that part of the cost is amortizable over the life of the negative covenant rather than of the asset and should be excluded from the basis. The purpose of the negative covenant must not be to eliminate competition indefinitely or permanently or it will be deemed tantamount to good will.[73]

7. If the property is a former residence that has been converted for income-producing purposes, its basis is its fair market value at the date of the conversion.[74] No adjustment of its basis need be made for any depreciation of the property prior to the conversion, since depreciation was not allowable as a deduction while it was still a residence.

8. Where property is demolished in order to permit rebuilding, the loss resulting from the demolition, that is, that part of the cost allocable to the old building, is added to the cost of the new structure. However, if one demolishes property without an intention to rebuild, the loss is currently deductible. If at some future date the erection of a new structure is decided upon, the demolition loss

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[66] *Koppers Coal* Co., 6 T.C. 1209 (1946); *Commissioner* v. *Ashland Oil & Refining Co.* (6 Cir. 1938), 99 F. 2d 588, 21 AFTR 1168; *Prairie Oil & Gas Co.* v. *Motter* (10 Cir. 1933), 66 F. 2d 309, 12 AFTR 996; *Kimbell-Diamond Milling Co.* v. *Commissioner* (5 Cir. 1951), 187 F. 2d 718, 40 AFTR 328, cert. den. 72 Sup. Ct. 50.

[67] 1954 IRC Sec. 334(b)(2).

[68] *Lang* v. *Commissioner*, 289 U.S. 109, 53 Sup. Ct. 534, 12 AFTR 45 (1933); I.T. 3785, 1946-1 C.B. 98; I.T. 3754, 1945 C.B. 143.

[69] 1954 IRC Sec. 1014(b)(9).

[70] *Wurlitzer* v. *Helvering* (6 Cir. 1936), 81 F. 2d 928, 17 AFTR 442.

[71] 1954 IRC Sec. 1014(b)(9). If the transferee should sell the property during the transferor's lifetime, however, the transferee's basis for determining gain or loss is a substituted basis.

[72] *Rainier Brewing Co.*, 7 T.C. 162 (1946); *X-Pando Corporation*, footnote 8, above.

[73] *The Toledo Blade Company*, 11 T.C. 1079 (1948); *Commissioner* v. *Gazette Telegraph Company* (10 Cir. 1954), 209 F. 2d 926; see *The Toledo Newspaper Co.*, 2 T.C. 794 (1943).

[74] *Helen D. Emmet*, et al., 11 T.C. 90 (1948); *Bert P. Newton*, 11 T.C. 512, 520 (1948); Reg. 118, Sec. 39.23(e)-1; Prop. Reg. Sec. 1.167(f)-1; *Parsons, et al.* v. *U.S.* (D.C., N.J. 1954), par. 72,315 *Prentice-Hall Tax Service*.

incurred in the earlier year may not be added to basis even though the loss resulted in no tax benefit.[75] Where, however, you purchase property with the intention of demolishing it and rebuilding, the entire purchase price is allocated to the land alone because it is considered that in view of your intention to demolish the building you attributed the entire value to the land.[76] Consequently, if you should contemplate the demolition of property, you ought to consider these questions and make an adequate record of your intention.

9. Where two or more assets are bought for a lump sum an equitable apportionment of the cost or other basis must be made, predicated upon the ratios of their respective values to their aggregate value.[77] This is also necessary if part of the assets so acquired is not subject to depreciation, as in the case of land improved by buildings.[78] Under such circumstances, appraisals should be obtained at the time of acquisition of the property. If the transaction can be arranged so that each asset is separately acquired for a specified consideration, the problem can be obviated; but a mere effort in the purchase contract to allocate an aggregate cost amongst the several assets acquired may not be successful. This is particularly true in the purchase of improved real estate, since in that case the allocation would patently have a tax purpose.

6. What Adjustments Should Be Made to Basis?

From time to time during the life of property, events occur that have the effect of modifying its basis for depreciation. The required adjustment may be either upward or downward. Since depreciation is the product of rate times base, any error in the base through failure to make a timely adjustment must necessarily result in an incorrect computation of the depreciation deduction.

The annual depreciation allowance must be predicated upon the facts known to exist at the end of each fiscal period.[79] Consequently, the base must be adjusted, either upward or downward as necessary, at the end of the year in which the event that affects it occurs. If the adjustment is not made as required and depreciation is reported on the incorrect base, the result will be either an inadequate or excessive deduction. If inadequate, basis is nevertheless reduced by the allowable depreciation; and unless the tax years involved are still open for the filing of amended returns or claims for refund, part of your capital investment will be wasted.

No adjustment may be made to basis for appreciation or diminution in the value of property, for increase in replacement costs, for shrinkage in the value of depreciation reserves or fluctuation in the value of the dollar.[80] Although balance sheets occasionally show appraisal value rather than book value of fixed assets, such appraisal value may not be employed in computing the depreciation deduction. Under the Code, the depreciation allowance is predicated upon cost (sometimes referred to as historical cost) uninfluenced by fluctuations in property or monetary values. Many corporations have set up additional reserves based upon the higher present costs in order to provide for future replacements, but such additional reserves are not permitted as tax deductions.

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[75] *Henry Phipps Estates*, 5 T.C. 964 (1945); *Commissioner* v. *Appleby* (2 Cir. 1941), 123 F. 2d 700, 28 AFTR 396.

[76] *N. W. Ayer & Son, Inc.*, 17 T.C. 631 (1951); *Lynchburg National Bank & Trust Co.*, 20 T.C. 670 (1953), affirmed (4 Cir. 1953), 208 F. 2d 757.

[77] *Sacramento Medical Dental Building Co.*, 47 B.T.A. 315, 328 (1942); *Nathan Blum*, 5 T.C. 702 (1945); Bulletin "F," page 2; *C. D. Johnson Lumber Corporation*, 12 T.C. 348 (1949).

[78] *Adda Inc.*, 9 T.C. 199 (1947), affirmed (2 Cir. 1948) 171 F. 2d 367, 37 AFTR 641.

[79] Bulletin F, page 2; Reg. 118, Sec. 3923(1)-5; Sec. 39.113(b)(1)-1; Prop. Reg. Sec. 1.167(b)-1. If you acquired property under circumstances requiring you to use predecessor's basis, adjustments including corrections must also be made in respect to the period during which the property was held by the predecessor. Reg. 118, Sec. 39.113(b)(2)-1; *Mendham Corporation*, 9 T.C. 320 (1947).

Adjustment should, however, be made to basis upon the happening of one or more of the following events:

1. When additions, improvements or restorations are made that tend to increase the value or add to the useful life of property the cost thereof must be added to basis.[81] Such items are properly chargeable to capital account.[82] As a corollary to this proposition, they are not deductible as ordinary expenses.[83] Frequently the line may not easily be drawn between current expense and capital expenditures.[84] If the expenditure, however, has the tendency to increase the value of the property or to increase its usefulness or to extend its life beyond "its probable, normal, useful life" instead of merely serving to maintain the property "in an ordinarily efficient operating condition," such expenditure should be capitalized.[85]

Capital expenditures incurred in rehabilitating property are often accounted for as a charge directly to the depreciation reserve.[86] Additions and replacements, plus the cost of installation, should, however, be added to the asset account, while the cost of the item which is replaced is deducted from the asset account and a charge therefor (adjusted for the amount of salvage) is made to the depreciation reserve.[87]

2. Where assets are disposed of through sale, retirement, casualty, or abandonment, or where assets are lost, their cost or other basis should be promptly eliminated from the asset account. The amount of depreciation accrued on such

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[80] The liberal depreciation allowances under 1954 IRC Sec. 167 are due in part to the agitation to amend the Code because of the disparity between the high replacement costs based upon postwar inflationary values and the low depreciation reserves computed upon costs incurred in prewar times. For general discussion on this subject see "Depreciation Policy When Price Levels Change," Controllership Foundation, Inc., published 1948; Beck, "Capital Replacement, Depreciation & Taxes," *Taxes*, July 1948, p. 658; Peloubet, "Are We Giving Away Our Capital Without Knowing It," *The New York Certified Public Accountant*, June 1948, page 440; "Business Profits During Inflation," *Harvard Business Review*, March 1948, page 222.

[81] *Illinois Merchants Trust Co.*, 4 B.T.A. 103 (1926); *American Bemberg Corp.*, 10 T.C. 361 (1948), affirmed (6 Cir. 1949) 177 F. 2d 200, 38 AFTR 758; *Difco Laboratories, Inc.*, 10 T.C. 660 (1948); *Midland Empire Packing Company*, 14 T.C. 635 (1950); *Black Hardware Co.* v. *Commissioner* (5 Cir. 1930), 39 F. 2d 460, 8 AFTR 10536, cert. den. 282 U.S. 841, where the court pointed out that it is sufficient that the improvement make the property more valuable to the taxpayer in his business although it does not increase its market value.

[82] 1939 IRC Sec. 113(b)(1)(A); 1954 IRC Sec. 1016(a); Reg. 118, sec. 39.113(b)(1)-1.

[83] 1939 IRC Sec. 24(a)(2 and 3); 1954 IRC Sec. 263; Reg. 118, sec. 39.23(a)-4.

[84] *P. Dougherty Co.* v. *Commissioner*, footnote 15, above.

[85] *Illinois Merchants Trust Co.*, footnote 81, above; Bulletin F, page 7; *Estate of Clarence B. Eaton*, 10 T.C. 869, 879 (1948); *Journal-Tribune Publishing Co.* v. *Commissioner* (8 Cir. 10/26/54) 216 F. 2d 138.

[86] Reg. 118, Sec. 39.23(a)-4.

[87] Bulletin F, page 7; Reg. 118, sec. 39.23(1)-4; *Toledo Terminal Railroad Co.*, 13 T.C. 64 (1949).

assets should be charged to the reserve account.[88] Losses incurred in regard to capital assets result in a reduction to basis in the year of occurrence even though no tax benefit was realized.[89]

3. The depreciable base of property, as pointed out above, consists of your cost or other basis, less estimated salvage value at the end of the useful life of the property.[90] If you should discover that your original estimate of salvage was materially inaccurate or that you failed to allow for salvage in the determination of basis, adjustment should promptly be made to basis by deducting the correct estimated salvage value. Failure to give effect to salvage not only may lead to disallowance of the depreciation deduction,[91] but all net receipts from salvage after the entire cost has been fully recovered through depreciation allowances will be treated as ordinary income.[92]

4. Basis is also required to be reduced in the case of a corporation which has realized income through the discharge of an indebtedness evidenced by a security, as defined in the Code, and desires to avail itself of the privilege of excluding such income from gross income subject to tax. A consent to reduction of basis by the amount of such excluded income must be filed by the corporate taxpayer at the time of filing the return for the year in which the indebtedness was discharged.[93]

5. Prior to 1942 a lessor of real property upon which improvements were erected by the lessee realized income in the year of termination of the lease to the extent of the value of the property represented by such improvements.[94] By amendment to the Code, in 1942, such income was held no longer to be includible in the lessor's gross income,[95] and the value of such improvements was not to be added to his basis of the property.[96] An amendment, however, also provided that, should any part of such income be included by the lessor in his gross income in a year prior to its effective date, basis of the property should be adjusted for the amount thereof.[97] If improvements were at any time made to your property by a lessee, it would therefore be desirable to check the basis that you have been employing in computing depreciation.

6. The Code also grants an important right of election to capitalize expenditures (1) in the case of unimproved and unproductive real property, (2) in the development or construction of improvements or additions to real property and (3) certain taxes and interest incurred in connection with the purchase, trans-

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[88] *Ibid.* Where depreciation is taken on assets which should have been eliminated from the asset account, it will be credited to the depreciation reserve of other assets upon which class or group depreciation was computed on a composite rate. *Reliable Incubator & Brooder Co.*, 6 T.C. 919, 927 (1946). See *Pittsburg Brewing Co.*, 37 B.T.A. 439, reversed on another point (3 Cir. 1939), 107 F. 2d 155, 23 AFTR 870.

[89] *Exchange State Bank*, 8 T.C. 721, 724 (1947).

[90] See Sec. 5 and citations in footnote 42.

[91] *Wier Long Leaf Lumber Co.*, 9 T.C. 990 (1947), reversed on other grounds (5 Cir. 1949), 173 F. 2d 549, 37 AFTR 1164; *U.S.* v. *Ludey*, footnote 9 above.

[92] Bulletin "F," page 7; *Wilson Line, Inc.*, 8 T.C. 394 (1947).

[93] 1939 IRC Secs. 22(b)(9), 113(b)(3); Reg. 118, Sec. 39.22(b)(9)-1; Sec. 39.22(b)(9)-2, Sec. 39.113(b)(3)-1; 1954 IRC Sec. 108(a); 1017.

[94] *Helvering* v. *Bruun*, 309 U.S. 461, 60 Sup. Ct. 631, 24 AFTR 652 (1940).

[95] Revenue Act of 1942, Sec. 115; 1939 IRC Sec. 22(b)(11); 1954 IRC Sec. 109; Reg. 118, Sec. 39.22(b)(11)-1.

[96] 1939 IRC Sec. 113(c); 1954 IRC Sec. 1019; Reg. 118, Sec. 39.113(c)-1.

[97] *Ibid.* The amendment is applicable to taxable years ending after January 1, 1941.

portation and installation of personal property.[98] Taxes, interest on mortgages, and other carrying charges on unimproved and unproductive real property are thus permitted to be added to basis. Accordingly an opportunity may be had to recoup such expenditures through depreciation allowances. Otherwise, in nonproductive years when there is no income against which to offset them, these expenditures would be reported with no possibility of any tax benefit therefrom. This right of election is particularly advantageous in the case of the demolition of buildings and the erection of a large structure where the work is commenced in one year but not completed until the next or subsequent years.

The election to capitalize such expenses must be made by filing a statement with the tax return indicating the item or items which you desire to charge to capital account. Such election need not be made as to all expenses, but to be valid it must embrace all items of the same type. When such election has once been exercised, however, you must continue to capitalize all future expenses of the same type which are incurred in the completion of the project.

If an expense should be incurred in part on a project or investment described in this paragraph and in part for ordinary business purposes, as, for example, compensation of a plant manager who devotes some of his time to supervising construction of an additional building, a reasonable apportionment should be made. Therefore, if you hold any unimproved or unproductive property which was acquired in connection with your trade or business or in a transaction entered into for profit, or if you contemplate the construction of substantial improvements to realty, you should consider the advantages of the right of election to capitalize taxes and other carrying charges incurred in connection therewith.

7. What Method Should You Use?

The 1954 Code has made important changes respecting methods of reporting depreciation. The aim of Congress, as pointed out above, was to liberalize depreciation allowances in the early years of service. It accomplished this purpose primarily through the extension of the use of the declining balance method and the alternative sum-of-the-digits method. The result has been a radical revision of the depreciation section of the Code which requires every taxpayer to reexamine his approach to the problem when new assets are acquired.

The law does not specify what method shall be used in computing depreciation. The only requirement which it imposes is that the allowance for exhaustion, wear and tear, including obsolescence of assets, be "reasonable."[99] The

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[98] 1939 IRC Sec. 24(a)(7); Reg. 111, Sec. 29.24-5; Reg. 111, Sec. 29.113(b)(1)-1; 1954 IRC Sec. 266. Prior to 1942, taxes and other carrying charges could, under 1939 IRC Sec. 113(b)(1)-(A), be capitalized only with respect to unimproved and unproductive real property. See I.T. 2701, XII-2 C.B. 76. The Revenue Act of 1942, Sec. 130(a) and (b), amended the Code by adding Sec. 24(a)(7) and amending 1939 IRC Sec. 113(b)(1)(A) so as to remove that limitation, effective for taxable years beginning after December 31, 1941. *Ernest A. Jackson*, 9 T.C. 307 (1947); *Warner Mountain Lumber Co.*, 9 T.C. 1171 (1947).

[99] 1939 IRC Sec. 23(l); 1954 IRC Sec. 167(a). See *Estate of Clarence B. Eaton*, footnote 85 above, in which the Tax Court said that an "accounting method, fortified by experience with use of equipment, is not to be lightly set aside," though the taxpayer's method in that case was not uniformly applied. See also *Toledo Terminal Railroad Co.*, 13 T.C. 64 (1949); The *Copifyer Lithograph Corp.*, 12 T.C. 728 (1949). In IR-Circular No. 144 the Service notes that under its new policy of generally not disturbing depreciation deductions, it will give careful consideration to whether the taxpayer has followed a consistent practice.

Regulations likewise suggest that you may employ any method which accords with a recognized trade practice provided that it is reasonable and has due regard to operating conditions during the taxable period.[100] The allowance should, however, be in accordance with a reasonably consistent plan though not necessarily at a uniform rate.[101]

It would be most desirable if the amount of depreciation actually sustained by your property could be appraised at the end of each year and if only that amount were credited to the reserve. That procedure has not only been approved in a number of cases but is considered by many to be preferable to any arbitrary system or method because in theory it aims to calculate the precise amount of depreciation sustained each year instead of employing a convenient formula that is admittedly a mere estimate.[102] However, it must be acknowledged that this method is difficult for the Service to administer, is cumbersome, and probably is too expensive for the average taxpayer. Congress has endeavored by means of the revised methods incorporated into the 1954 Code to provide a formula which may accomplish the same result by effecting "a timing of allowances more in accord with the actual pattern of loss of economic usefulness." [103]

Straight-line method. The method that is most widely used is the straight-line method. Until the enactment of the 1954 Code the Treasury favored it because it has the advantage of simplicity.[104] By this method the basis[105] of your property (less estimated salvage value) is deducted in equal annual installments over the period of its estimated useful life. It assumes in principle that under normal conditions the property will exhaust itself at a uniform rate throughout that period. By stressing "loss of economic usefulness" rather than physical exhaustion of the property, Congress has recently acknowledged, however, that the straight-line method may not be the most practicable or desirable way of recovering one's investment in depreciable assets. Nevertheless, the straight-line method is still retained in the law as the standard for determining the maximum amount of depreciation allowances permissible under any method that you may adopt.

Property eligible for accelerated methods. The declining-balance method and the sum-of-the-digits method have been given prominence by the new Code. They make it possible for one to recover his investment in new assets at a much faster rate than by the straight-line method and, therefore, every taxpayer must study the advantages of these methods in the light of his own business circumstances.

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[100] Reg. 111, Sec. 29.23(1)-5.

[101] Prop. Reg. Sec. 1.167(a)-1.

[102] *Cumberland Glass Mfg. Co.* v. *U.S.* (Ct. Cls. 1930), 44 F. 2d 455, 9 AFTR 377; *Geuder, Paeschke, and Frey Co.* v. *Commissioner* (7 Cir. 1930), 41 F. 2d 308, 8 AFTR 10861; *Albia Box & Paper Co.,* 4 B.T.A. 1184 (1926).

[103] Sen. Rep. No. 1622, 83rd Cong., 2d Sess., p. 25.

[104] Bulletin "F," page 4.

[105] Only historical cost may be recovered through depreciation allowances. A thorough accounting system aims to charge into cost of operations an amount which accurately reflects the cost of that part of plant and equipment which is used up or expended in the production of goods. In principle that quantum of cost enters into and comprises part of the price for which the goods are sold. If, as Mr. Justice Brandeis said in *U.S.* v. *Ludey* (see footnote 9 above), "by using up the plant a gradual sale is made of it," it must follow that if depreciation is computed on historical cost instead of the current market value of the plant, the purchaser of the manufactured goods pays for the plant at a price which is unrelated to the reality of the market place. Nevertheless, under the Code no effect may be given to fluctuations in the value of property. See *Wier Long Leaf Lumber Co.,* footnote 91 above, and also footnote 12.

General conditions for the use of the liberalized declining-balance method and the sum-of-the-digits method are as follows:[106]

1. These methods are applicable only to new property acquired or constructed after December 31, 1953, i.e., new in use and therefore never before subject to depreciation allowances to anyone.[107]
2. If the property consists of a plant or building that was in the course of construction by or for your account at December 31, 1953 and was completed subsequently, only that part of the property's basis attributable to the post-1953 construction is eligible. The remainder of your basis is subject to depreciation by the method you have been using for similar assets in prior years.
3. The property must have a useful life of not less than 3 years.

Declining balance method. This method allows a greater amount of depreciation in the early years than any other method, particularly in the first year. It permits the use of a rate not exceeding twice the annual allowance computed under the straight-line method.[108] The rate under this method is applied to the basis of the property reduced by the amount of prior years' depreciation, in other words to each year's declining balance rather than to the original basis as under the straight-line method. On used assets, as distinguished from newly acquired eligible property, the declining-balance rate, where that method is used, may not exceed 150% of the straight-line rate.[109]

Furthermore, unlike other methods, the amount of basis to which the rate is applied under declining-balance procedure is not reduced by estimated salvage value.[110] The unrecovered cost that will remain when the asset is either sold or abandoned is deductible as a loss in that year, provided that, as discussed in Section 8, infra, you employ single item accounts. In group accounting if you maintain records of your depreciable assets by year of acquisition, the unrecovered cost of a given year's acquisitions may be deducted at the time of retirement of the last surviving unit.[111]

If an asset is acquired some time during the year, the depreciation allowance is computed as though the asset had a fiscal year beginning with the first day of the month nearest the date of acquisition. The allowance is then prorated between the taxable year of acquisition and the next succeeding year according to the number of months in each said year. The procedure is repeated for each subsequent year during the life of the asset.

Sum-of-the-digits method. Under this method basis, reduced by estimated salvage, is multiplied annually by a changing fraction the numerator of which corresponds to the remaining years of useful life and denominator to the sum of all the years of useful life. For example, if the asset has a 5-year life, the denominator represented by 5 + 4 + 3 + 2 + 1 equals 15, and the numerator in the first year is 5, in the second year 4, etc. The annual depreciation allowances in the case of an asset with a basis of $1750 and a salvage value of $250, are shown in Table 29-1.[112]

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[106] Prop. Reg. Sec. 1.167(b)-1 (b)(2) and (3).

[107] 1954 IRC Sec. 167(c).

[108] 1954 IRC Sec. 167(b)(2).

[109] I.T. 3818, 1946-2 C.B. 42; see also Bureau rulings published in 1946 *Prentice-Hall Federal Tax Service*, par. 76,264 and par. 72,268. In I.T. 3818 the Bureau modified its earlier ruling in I.T. 2369, VI-2 C.B. 63, where it had stated that it would not approve or disapprove the use of this method in advance of the audit of a taxpayer's return.

[110] House Rep. No. 1337, 83rd Cong., 2nd Sess., p. A48; Prop. Reg. Sec. 1.167(b)(2).

[111] Sen. Rep. No. 1622, 83rd Cong., 2nd Sess., p. 27; Prop. Reg. Sec. 1.167(b)-1 (b)(2).

TABLE 29-1

YEAR	BASIS LESS SALVAGE	FRACTION	ALLOWABLE DEPRECIATION	DEPRECIATION RESERVE
1954	$1500.00	5/15	$500.00	$ 500.00
1955	1500.00	4/15	400.00	900.00
1956	1500.00	3/15	300.00	1200.00
1957	1500.00	2/15	200.00	1400.00
1958	1500.00	1/15	100.00	1500.00

For the same item of property, the schedule in Table 29-2 illustrates the results of computing depreciation under the afore-mentioned three methods. This schedule demonstrates that the allowance under the declining-balance method is considerably greater in the first year than under the sum-of-the-digits method. The annual decrease in the amount of the depreciation allowance is less precipitate under the latter method, however, and some taxpayers may therefore prefer this method so as to avoid a possible distortion of net income that may result from the reporting of unusually large depreciation deductions in years of major acquisitions.

The following rules, applicable to both of these methods, should be remembered:

1. No formal election is necessary in order to adopt either of these methods. The election is made merely by computing depreciation by the desired method in the return for the first taxable year in which you may take depreciation on the property.[113]

2. You are not required to use the same method for all of your depreciable assets. If you employ item accounts, you may select different methods for different items; but if you have classified, group or composite accounts, all items in a single account must use the same method.[114]

3. Any method that is selected must thereafter be applied consistently to the item or to the account for which it has been chosen.[115]

4. The election to use one of the methods for any property is not binding with respect to any property acquired in a subsequent taxable year. You may choose a different method for the latter property.[116]

5. If you adopt the declining-balance method for any asset you may change to the straight-line method at any time during its useful life without the consent of the Commissioner.[117] The unrecovered cost at that time (less a reasonable

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[112] Prop. Reg. Sec. 1.167(b)-1 (b)(3).

[113] House Rep. No. 1337, 83rd Cong., 2nd Sess., p. A50; Prop. Reg. Sec. 1.167(c)-1 (c)(2).

[114] *Ibid.*

[115] Sen. Rep. No. 1622, 83rd Cong., 2nd Sess., p. 204.

[116] Prop. Reg. Sec. 1.167(c)(2).

[117] Prop. Reg. Sec. 1.167(e)-1. A statement as to the date of acquisition of the property and all other material facts must be submitted with the return for the taxable year in which the change is made. See also Reg. 118, Sec. 39.41-2.

TABLE 29-2

YEAR	STRAIGHT-LINE METHOD			DECLINING-BALANCE METHOD			SUM-OF-THE-DIGITS METHOD		
	Basis (Less Salvage)	Allowable Depreciation (20%)	Depreciation Reserve	Basis	Allowable Depreciation (40%)	Depreciation Reserve	Basis (Less Salvage)	Allowable Depreciation	Depreciation Reserve
1954	$1500.	$300.	$ 300.	$1750.	$700.	$ 700.	$1500.	$500.	$ 500.
1955	1500.	300.	600.	1050.	420.	1120.	1500.	400.	900.
1956	1500.	300.	900.	630.	252.	1372.	1500.	300.	1200.
1957	1500.	300.	1200.	478.	191.	1563.	1500.	200.	1400.
1958	1500.	300.	1500.	287.	114.	1677.	1500.	100.	1500.
Unrecovered Value (Salvage)			$250.			$73.			$250.

estimate for salvage) is then spread over the remaining useful life of the property based upon then prevailing conditions. Any other change in method of depreciation is a change in accounting method and requires the consent of the Commissioner.

Other depreciation methods. The 1954 Code makes specific mention of only those methods referred to above. However, Congress has stated that all methods which have been allowed in the past and allowances pursuant to any such method which have proved reasonable under the 1939 Code will continue to be allowed.[118]

The new Code also expressly provides that you may use any other consistent method which, during the first two-thirds of the useful life of the property, does not result in accumulated allowances at the end of any year greater than the total of the accumulated allowances which would have resulted from the use of the declining-balance method.[119] The limitation has been omitted for the last third of useful life because Congress recognized that during that period the depreciation allowances under the declining-balance method are relatively low and because of the large residual value under that method.[120]

There are other depreciation methods than those mentioned above, but none is in common use. The only ones that need be mentioned are the unit-of-production method and the retirement method.

The unit of production method is not adaptable to many types of property, but when it can be used it will be found to represent a reasonably accurate and satisfying system of reporting depreciation. Its object is to amortize or prorate the cost or other basis of a machine, for example, over the estimated number of units which that machine will produce during its useful life.[121] The cost or other basis of the machine, less salvage value, is divided by this estimated number of units to obtain the cost per unit. The number of units actually manufactured in each year is then multiplied by this unit cost to obtain the total allowable depreciation on the machine for that year. The allowable depreciation deduction, therefore, varies annually and is in reasonably direct proportion to the number of units produced. Thus, in slack years the depreciation allowance is likely to be commensurate with the volume of business transacted. The Service, however, will probably disapprove of your use of the unit of production method except where the rate of production has a direct relation to the rate of exhaustion, as in the case of equipment for mines and oil wells.[122]

The retirement method is available principally to taxpayers such as railroads and utility companies whose annual maintenance and retirement are large and relatively constant in amount.[123] Since the nature of the business requires a systematic and continuous making of repairs, renewals, and replacements, the property as a whole is considered as valuable at the end of the year as at the beginning. Consequently, no items are capitalized and amortized on any straight-line method, but each year's maintenance, repairs, and retirements are charged to expense. Although there are years in which there may be distortion because of retirement of an expensive item, the tendency of the "law of averages" will be to balance such expenditures with the actual depreciation.

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[118] Sen. Rep. No. 1622, 83rd Cong., 2nd Sess., p. 26.

[119] 1954 IRC Sec. 167(b)(4).

[120] Sen. Rep. No. 1622, 83rd Cong., 2nd Sess., p. 27.

[121] Bulletin "F," page 4.

[122] *Ibid. Evangeline Gravel Co. Inc.*, 13 B.T.A. 101 (1928); *Shriner Oil & Manufacturing Co.*, 11 B.T.A. 805 (1928); *Rainbow Gasoline Corporation*, 31 B.T.A. 1050 (1935); *Golconda Oil Co.*, 7 B.T.A. 955 (1927).

[123] *Chicago & N.W.R. Co.* v. *Commissioner* (7 Cir. 1940), 114 F. 2d 882, 25 AFTR 744; cert. den., 61 Sup. Ct. 711; *Los Angeles & Salt Lake R. Co.*, 4 T.C. 634, 648 (1945); *Boston and Maine Railroad* v. *Commissioner* (1 Cir. 1953), 206 F. 2d 617.

The retirement method is also frequently employed in analogous situations where there is a more or less constant annual retirement and replacement, as in the case of steel drums and barrels.[124] If such items have a useful life of a year or less they should be charged as an expense,[125] or if their cost is charged to the customer when not returned, the proper practice is to include them in the inventory.[126]

8. What Accounts Shall You Use?

For the purpose of computing your depreciation allowance, the property subject to depreciation must be recorded in proper accounts in your records and the kind of accounts that you select may have an important bearing on the accuracy of that allowance. Depreciation accounts fall into four general classes: items accounts, classified acounts, group accounts and composite accounts.

The item or unit account requires a separate record of cost and reserve for each individual major asset and, consequently, the useful life of each such asset must be separately determined.

The other three accounts are variations or types of composite accounts. In classified accounting, assets are segregated into separate accounts according to use, and each group has a separate reserve and separate rate. In group accounting, the assets which have approximately the same average useful lives are grouped together. In composite accounting all of your assets are lumped in a single account and an over-all composite rate is applied to the aggregate basis of these assets.

The Service prefers the classified accounting method, wherein the greatest number of similar assets fall into the same group. Use of this method simplifies the administrative problem, since a single rate is applied to an aggregate basis representing numerous similar items in order to obtain a single credit to the reserve account.[127]

For the average taxpayer, any composite grouping will probably offer no advantage other than convenience. The tendency is to adopt a few classified accounts and to lump all machinery in a single account for machinery and equipment. In such an account a single rate is fixed for all items regardless of their expected useful lives. The weighting of lives and costs which should be employed in fixing the rate is only roughly made, if at all, and, therefore, it may be expected that the average which the Service will approve will be considerably below the longest and above the shortest lives of the assets in the group. When adjustments are required to be made to the basis or rate of the composite group because of abnormal retirements, losses, or obsolescence, or because experience has proven that the rate theretofore used is incorrect, the computations are difficult and proof is expensive. For these reasons the taxpayer is frequently compelled to compromise on an adjustment in which part of his capital investment is lost.[128]

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[124] *U.S. Industrial Alcohol Co.* v. *Helvering* (2 Cir. 1943), 137 F. 2d 511, 31 AFTR 425.

[125] *J. E. Mergott Co.*, 11 T.C. 47 (1948), affirmed (3 Cir. 1949), 176 F. 2d 860, 38 AFTR 507.

[126] *Read Phosphate Co.*, 13 B.T.A. 39 (1928).

[127] Bulletin "F," page 6.

Moreover, deductions are usually denied and the taxpayer is put to his proof, which is often difficult, where he claims losses for abnormal retirements, obsolescence, and similar losses respecting assets in a composite group. Losses on the normal retirement of such assets are not allowable since the use of an average rate contemplates the retirement of assets both before and after the average life has been reached. There is, therefore, no possibility of determining whether any actual loss has been suffered until all the assets in the composite group have been retired.[129] The composite rate assumes, in theory, that some assets will be retired before and some after the average, and therefore those reaching the end of their expected life, whether before or after the average, do not result in loss. The entire cost of such retired assets, less salvage, is charged to the depreciation reserve account. In that way the full cost or other basis can be recovered through depreciation allowances, even though they are retired in advance of the average life of the entire group.

If loss is claimed on an abnormal retirement, the taxpayer must show by clear and convincing evidence not only that the asset was disposed of before the expiration of its normal useful life, but also that such early disposition was not contemplated in fixing the composite or average rate of all assets in the group. In the case of unit or item accounts, the problem of the retired asset is unrelated to other assets and it is easier to establish the factors which entered into the original determination of the rate or useful life of a single item. If there is an abnormal retirement or sale of an asset in a composite group, the basis for determining gain or loss on the asset is then recomputed. This is accomplished by deducting the amount of depreciation "allowable" for all prior years as though the asset had been depreciated on a unit or item basis, rather than as one of a composite group. In other words, regardless of the amount of depreciation which has been reported on the asset in prior years, the remaining undepreciated cost is recomputed after a redetermination of the allowable depreciation on a unit basis.[130]

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[128] Although, under the unit or item method, depreciation reported on one asset after it has been exhausted may not be applied against the basis of other similar assets in the plant account (*Pittsburgh Brewing Co.* 37 B.T.A. 439 (1937), reversed on other grounds (3 Cir. 1939) 107 F. 2d 155, 23 AFTR 870), any excess depreciation reported on certain assets in prior years will be credited to the reserve of the composite group in which they are included. *Reliable Incubator & Brooder Co.*, 6 T.C. 919, 927 (1946).

[129] Mim. 4170, 1934-1 C.B. 59; *Toledo Terminal Railroad Co.*, 13 T.C. 64 (1949); Prop. Reg. Sec. 1.167(a)-1(c). For a consummate analysis of the composite rate basis and the treatment of retirements from the account see the opinion of Opper, J., in the *U.S. Industrial Alcohol Co.*, 42 B.T.A. 1323 at 1375 and following. (Modified in 137 F. 2d 511, 31 AFTR 425.) See also *Aetna-Standard Engineering Co.*, 15 T.C. 284 (1950). Bulletin F points out at page 7 that losses from normal retirement are not allowable under any method "unless, in the case of classified or group accounting, the depreciation rate is based on the expected life of the longest-lived asset in the group, and in item accounting only when the maximum expected life of the asset is used."

[130] *U.S. Industrial Alcohol Co.*, footnote 129, above.

Under the declining-balance method, it is particularly desirable to use item accounts. Not only does this simplify the reporting of a loss when an asset is sold or abandoned, but if you should at any time desire to switch to the straight-line method it would be essential that your records enable you to compute a separate reserve for the asset. Regardless of the type of group account you may use, in order to have sufficient information to determine (1) the year in which the last survivor of a given year's acquisitions is retired and (2) the unrecovered cost of that year's acquisitions, you must maintain subsidiary depreciation records by year of acquisition.[131]

The use of composite accounting, which is simpler and more convenient, will probably be less expensive at the outset. However, the initial saving may be more than offset by adjustments and by expenses incurred when substantial eliminations through abnormal retirements, obsolescence, losses, or sales occur. Detailed property records also permit better control of the dollar amount of the investment.

9. How Is Rate or Useful Life Determined?

Determination of the useful life of property is the most troublesome as well as the most important phase of the subject of depreciation. Since one's capital investment in an asset is recoverable over its useful life, and the natural desire of most people is to recover that investment as quickly as possible, the tendency is to ascribe as low an estimate as possible to the normal life of the asset. For several reasons the wisdom of this practice is debatable.

First, whenever the Service discovers that the rate of depreciation used is excessive, the remaining useful life must be redetermined and the unrecovered cost is then spread over such remaining life.

Second, over the life span of property it is probable that the average business will have a few loss years. There is no possible way of anticipating when loss years will occur. The taxpayer then has the burden, which is difficult and expensive in depreciation cases, of going back over prior years and establishing that on the facts known to exist in those years the rates used by the taxpayer were excessive.

Third, since tax rates may change and one cannot always anticipate the direction of the change, it follows that the tax benefits which will flow in the future from excess depreciation deductions are an unknown quantity. If the rates should increase in later years, the taxpayer finds that his excess deductions of prior years resulted in lesser tax savings.

Fourth, from a proper accounting and economic viewpoint, the actual depreciation sustained annually should enter into the computation of cost of goods sold. This in turn should determine the price to the ultimate consumer. If the capital investment in an asset is recovered long before the expiration of its useful life, then in the remaining years no depreciation is reflected in the cost of goods sold. This factor is also to be considered in determining whether to select one of the accelerated depreciation methods provided by the 1954 Code.

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[131] House Rep. No. 1337, 83rd Cong., 2nd Sess., p. A51.

Fifth, the temptation is great to take larger depreciation deductions in high tax years which are usually the years of larger incomes. In such years, however, the taxpayer can most afford to take a lesser deduction. Many taxpayers who are now depreciating their assets at a faster rate than experience justifies will find when low-profit years return, and every dollar counts, that they have long since exhausted the basis of their assets and are badly in need of the depreciation allowance. In addition, if the error was substantial they may then find themselves faced with a deficiency in tax plus interest, because of excessive deductions in prior years.

It is recommended that the soundest economic course is to make the most practical and accurate estimate possible of the useful life of your assets. If you believe that the lives of assets which you have been using may not have been carefully determined or that conditions have altered since their useful lives were first fixed, a prompt reappraisal should be made and adjustments should be effected where errors are discovered.

In determining the useful life of property the following are the principal factors which must be taken into consideration: (1) the physical life of the property, (2) obsolescence, and (3) maintenance policy.[132] There are a number of other factors that, in individual cases, may have greater or lesser bearing on the subject of useful life: for example, atmospheric conditions under which the property will be operated, quality of the labor or personnel available, quality or character of the raw material upon which the machine is intended to be used, the number of shifts which in your industry constitutes a normal operation, and so forth.[133] In the main, however, the three factors: actual physical life, obsolescence, and maintenance policy, will control the determination of the estimated useful life of property.

You begin by endeavoring to estimate how long the asset will be useful in your business under normal conditions. What is "normal," of course, involves the consideration of a host of variable quantities and conditions. Bulletin "F" contains a number of schedules which list the estimated useful lives and rates of properties in various industries under what the Treasury Department regards as "average" conditions.[134] These estimates are offered, however, as a guide or starting point—they are not controlling on the Service or the taxpayer and they should not be used without a thorough consideration of the specific conditions in your own operation which are likely to influence the rate of depreciation and useful lives of your assets.

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[132] Bulletin "F," page 3; Reg. 118, Sec. 39.23(l)-1. In *Adda, Inc.*, 9 T.C. 199, 209 (1947), affirmed (2 Cir. 1948) 171 F. 2d 367, 37 AFTR 641, the court used the concept of "economic" useful life because of the special circumstances involved. It found that although the property probably had a physical life of 40 years from the date of acquisition, depreciation should be allowed over the "economic and useful life" of 21 years at which time, because of economic factors, the owner of the property would be required to demolish the building and erect another.

[133] *Estate of Clarence B. Eaton*, 10 T.C. 869, 872 (1948).

[134] The preamble on the frontispiece of Bulletin "F" says with regard to the data contained therein: "Taxpayers and officers of the Bureau are cautioned against reaching conclusions in any case solely on information contained herein and should base their judgment on the application of all pertinent provisions of the law, regulations, and other Treasury Decisions to all the facts in any particular case. The estimated useful lives and rates of depreciation indicated in this bulletin are based on averages and are not prescribed for use in any particular case. They are set forth solely as a guide or starting point from which correct rates may be determined in the light of the experience of the property under consideration and all other pertinent evidence."

The number of years of physical life which can be ascribed to your property and the period by which obsolescence can be expected to shorten such property's useful life are matters of expert opinion.[135] Few taxpayers are qualified by experience to form a reliable opinion of the time when the usefulness of their property will exhaust itself through wear and tear, decay, and obsolescence. Most taxpayers, therefore, either adopt the Bulletin's estimate or accept their accountant's view or published statements of how other taxpayers are treating somewhat similar assets, or make a rough, general estimate which does not take into account their own specific problems or operating conditions.

If your plant account is of sufficient size so that the amount of the depreciation allowance is an amportant item, it is recommended that you employ competent appraisal engineers to determine the probable useful lives of your assets and compute the proper rate of depreciation in the light of the various conditions which exist in your own operation. Experience is ample to show that many substantial companies not only have no intelligent, planned depreciation policy, but that they also use a haphazard, amateurish method of estimating the useful lives and depreciation rates of their assets. Here again, the matter of expense may be a deterrent to some taxpayers in having such an appraisal made, but this is a shortsighted policy since, firstly, the professional appraisal of competent engineers is preferred by the Service to the guesswork of unqualified taxpayers, and, secondly, the resulting savings in litigation costs and in control of capital investment will usually compensate for such expense.

In order to eliminate the possibility of disputes over determination of the useful lives of assets, you may negotiate an agreement with the Commissioner.[136] The new Code provides that such an agreement is binding on the parties in the absence of facts and circumstances not taken into consideration in the adoption of the agreement. When once consummated the agreement can only be changed prospectively, and then only on proof that such facts and circumstances did exist.

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[135] The part that fact and opinion play in determining useful life and the factors to be considered are described in Bulletin "F," page 3, as follows: "Past experience, which is a matter of fact and not of opinion, coupled with informed opinion as to the present condition of the property, and current developments within the industry and the particular trade or business, furnish a reliable guide for the determination of the useful life of the property. Such a determination should reflect all the peculiar circumstances of the use or operation of the property such as the purpose for which it is utilized, the conditions under which it is used or operated, the policy as to repairs, renewals, and improvements, and the climatic and other local conditions." A bare statement of opinion as to the estimated, useful life unsupported by evidentiary facts warranting that opinion is insufficient to overcome the presumption of the correctness of the Commissioner's determination. The expert should be competent and experienced in appraising the useful lives of similar properties. *W. F. Trimble Co.*, 1 T.C. 482 (1943). Although in a few cases, where the Bureau arbitrarily allowed no depreciation at all, The Tax Court made its own estimate on the principle of *Cohan* v. *Commissioner*, 39 F. 2d 540, 8 AFTR 10552 (C.C.A.-2-1930) and allowed some depreciation despite the failure of proof, a taxpayer would be ill-advised to place much reliance thereon except in the special circumstances described in those cases. *Irene L. Bell*, 13 T.C. 344 (1949); *Tressler Coal Mining Co.*, T.C. Memo. Dec. Dkt. No. 11060, December 8, 1948, par. 48,266 Prentice-Hall Memorandum T.C. . . .

[136] 1954 IRC Sec. 167(d). In Mim. 5881, which was published June 14, 1945 (par. 14,123-B *Prentice-Hall Federal Tax Service*), the Bureau announced that taxpayers could apply for agreements fixing the method and rates for depreciation of existing assets for 5-year periods. It stipulated, however, that such an agreement would not preclude adjustments due to changes in economic conditions.

10. What Is Obsolescence and How Is It Treated?

Many properties, such as machines, cease to have any economic use before they are fully exhausted by wear and tear or decay. Their useful lives are foreshortened by inventions, technological progress in the arts or sciences, changing economic conditions, the enactment of legislation, or similar occurrences.[137] When past experience with such assets indicates a gradual lessening of useful value owing to such factors, and shows that the same or a similar influence may be anticipated "with substantially the same degree of accuracy" as wear and tear, decay or corrosion, the assets are deemed subject to normal obsolescence.[138] In estimating the normal useful life of property for depreciation purposes, you must give effect to such normal obsolescence by including it in the depreciation deduction. This inclusion has the result of reducing the anticipated useful life below the actual physical life, since obsolescence factors are expected to curtail the economic usefulness of the property before it is physically exhausted.

It must be remembered that allowance is made for normal obsolescence in the depreciation rate because it is a process that is regarded as taking place gradually during the useful life of the property.[139] Additional obsolescence occurring during the use of the property, not contemplated at the time the rate was fixed, is called abnormal or extraordinary obsolescence. A special deduction is allowed for it. This phase of the problem is treated below in Section 12(2).

Although it is probably more difficult to estimate how much should be allowed for obsolescence than for wear and tear, failure to give effect to normal obsolescence in fixing useful life and rate of depreciation may result in wasting part of your capital investment. Obsolescence may not be applied retrospectively, but must be apportioned over the period in which it is deemed to occur.[140] Therefore, since obsolescence takes place to some extent in the case of most depreciable assets, it should be considered at the outset in fixing the useful life and rate of depreciation of your property.

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[137] *Real Estate-Land Title & Trust Co.* v. *U.S.*, 309 U.S. 13, 60 Sup. Ct. 371, 23 AFTR 816 (1940); *U.S.* v. *Wagner Electric Mfg. Co.* (8 Cir. 1932), 61 F. 2d 204, 11 AFTR 919; *United States Cartridge Co.* v. *U.S.*, 284 U.S. 511, 52 Sup. Ct. 243, 10 AFTR 790 (1943); *Burnet* v. *Niagara Falls Brewing Co.*, 282 U.S. 648, 51 Sup. Ct. 262, 9 AFTR 978 (1931); *V. Loewers Cambrinus Brewery Co.* v. *Anderson*, 282 U.S. 638, 51 Sup. Ct. 260, 9 AFTR 976 (1931).

[138] 1939 IRC Secs 23(1), 113(b)(1)(B); 1954 IRC Sec. 167, Sec. 1016; Reg. 118, Sec. 39.23(1)-2 and 39.23(1)-6; Bulletin "F," pages 1-3.

[139] *W. B. Davis & Son, Inc.*, 5 T.C. 1195, 1217 (1945). See the *S. S. White Dental Mfg. Co.* v. *U.S.*, 55 F. Supp. 117, 32 AFTR 804 (Ct. Cls. 1944) in which the court allowed a claim for loss of useful value after a claim of obsolescence had previously been denied in 38 F. Supp. 301, 26 AFTR 1094 (Ct. Cl. 1941). In allowing the claim the court makes the very important distinction between allowances for obsolescence and deductions for loss of useful value. It points out that the Regulations (Reg. 94, Art. 23(e)-3) state that loss of useful value occurs "When, through some change in business conditions, the usefulness in the business of some or all of the capital assets is suddenly terminated," whereas obsolescence is the result of "those gradual processes for which depreciation allowances are authorized."

[140] *W. B. Davis & Son, Inc.*, footnote 138, above, at page 1217; *Olean Times-Herald Corporation*, 37 B.T.A. 922, 925 (1938).

11. What Effect Shall Be Given to Maintenance?

The maintenance policy of a taxpayer is an important factor in determining the useful life of property. Obviously, property may depreciate at a faster rate and have a shorter life where a taxpayer has a small plant and little capital and, therefore, is unable to afford an adequate maintenance policy that may call for periodic shut downs, sufficient repair men, overtime labor costs, inventories of spare parts, and similar items.[141] In determining useful life of property at the time of its acquisition, consideration should be given to this phase of the subject.

In some cases, maintenance can be a dominant factor. For example, motor carriers, busses, trucks, trailers and taxicabs operating over regular routes or as part of substantial fleets or systems, have special maintenance problems because of the inherent character of the operation.[142] Depreciation in such cases is, of course, dependent in great part upon the extent and quality of the maintenance. Annual maintenance costs are in turn influenced by the remaining useful life of such assets. It is apparent that in that type of operation, depreciation and maintenance are closely interrelated factors.

Normal or average rates of depreciation, such as are furnished by the Service in Bulletin "F," contemplate "a reasonable expense policy" for maintenance to keep the assets in fair operating condition. If your circumstances are such that you are able to anticipate that a greater or lesser amount than average maintenance will be incurred during the life of your property, effect should be given to such variance in fixing its useful life and rate of depreciation.

12. How and When Shall Adjustments Be Made?

We are constantly being reminded by the Treasury Department and the courts that the amount of depreciation allowable in any year must be determined in accordance with the facts reasonably known to exist at the end of the year.[143] Hence, the allowable deduction is dependent upon the condition of the property at the end of the year, and not necessarily upon the previously determined useful life or rate. Since, as noted, the basis of your property must be reduced by the allowable depreciation, whether reported or not, a sound depreciation policy requires that before computing your annual deduction you consider whether operating conditions or other events during the year warrant adjustment to basis, useful life, or rate of depreciation. However, in view of the Service's new policy toward minor variations in allowable depreciation, changes occurring during a taxable year are not likely to call for an adjustment unless they are of major importance. The following are some of the subjects to be considered:

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[141] Reg. 118, Sec. 39.23(1)-1, states that in computing depreciation "Due regard must also be given to expenditures for current upkeep." Bulletin "F" provides that such determination should reflect "the policy as to repairs" and "the maintenance and replacement policy of the taxpayer and the accounting practice regarding the same" (page 11). See also *Leonard Refineries, Inc.* 11 T.C. 1000, 1007 (1948) and IR-Circular No. 144.

[142] *Nathaniel L. Fish*, "Maintenance as a Factor in Determining Depreciation for Motor Carrier Equipment," *The New York Certified Public Accountant*, November 1948, Vol. XVIII, page 820.

[143] *Commissioner* v. *Mutual Fertilizer Co.* (5 Cir. 1947), 159 F. 2d 470, 35 AFTR 792; *Commissioner* v. *Cleveland Adolph Mayer Corporation* (6 Cir. 1947), 160 F. 2d 1012, 35 AFTR 1082; Reg. 118, Sec. 39.23(1)-5; Bulletin "F," page 2.

a. Corrections of errors. Most taxpayers employ the straight-line method which assumes that property will exhaust itself at a uniform rate throughout its estimated useful life. When it is discovered that in prior years there has been an error in the base or in the estimated useful life or rate used, or if you neglected for any reason[144] to report depreciation on an asset, correction should promptly be made. The unrecovered cost of the property, as adjusted, is then spread ratably over the estimated remaining useful life.[145] Where an error was made with respect to one or more assets in a composite group which has numerous assets with varying remaining lives, the adjustment is more complicated. You are there required to recompute the weighted average remaining life of the group. The unrecovered cost of the entire group is then prorated over this redetermined average remaining life.[146]

b. Abnormal obsolescence. Unforeseen and unpredictable obsolescence due to a development or technological improvement that is made after acquisition of the property and not already allowed for in the normal depreciation rate is the subject of a special deduction. It is important to remember that abnormal obsolescence is not necessarily a sudden event that leads to abandonment or retirement of the asset in the year of its occurrence. On the contrary, it is usually the result of some unexpected development from which it may be determined with reasonable accuracy that within a specified period of years the economic usefulness of the asset will end prior to the expiration of its normal useful life.[147] Although Bulletin "F" indicates that the evidence of the period of abnormal obsolescence must be "definite and indisputable" and that it must appear "that a point has been reached where it can be *definitely* predicted that its use for its present purpose will be discontinued at a *certain* future date,"[148] the application of the rule is more liberal than that. A reasonable approximation, based, of course, upon a fair showing of facts, is sufficient.[149]

However, the amount of abnormal obsolescence must be apportioned over the period beginning with the time when such obsolescence becomes apparent and ending with the time when the property becomes useless. The taxpayer, of course, has the burden of proving the period in which the obsolescence was or will be in progress. No amount may be charged off retrospectively because of hindsight or because one failed to take advantage of an available deduction in a prior year.

c. Accelerated and decelerated depreciation. As the term "accelerated depreciation" is here used it has no reference to the liberalized declining-balance or sum-of-the-digits methods. It is recognized by the Service that property may in some instances be subjected to substantially increased or reduced activity as the result of which the normal rate of depreciation for such property may not be appropriate. In fact, where radically increased or reduced depreciation occurs, it is a requirement that effect be given thereto; otherwise the taxpayer will be reporting either a lesser amount or a greater amount than the "allowable" depreciation.[150]

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[144] See citations in footnote 143, above.

[145] *Virginian Hotel Corporation* v. *Helvering,* footnote 7 above.

[146] Bulletin "F," page 9.

[147] See cases cited in footnote 137, above.

[148] Bulletin "F," page 3.

[149] *Burnet* v. *Niagara Falls Brewing Co.,* footnote 119 above; *Pierce Oil Corporation,* 32 B.T.A. 403, 436 (1935). In the Niagara Falls Brewing Co. case the Supreme Court, in passing upon the obsolescence of brewery plants and equipment which resulted from the approach of the effective date of the 18th Amendment to the Constitution, said it would be unreasonable to require proof of obsolescence "to a reasonable certainty" and that "A reasonable approximation of the amount that fairly may be included in the accounts of any year is all that is required."

Accelerated depreciation may be due to any one or more of the following factors:[151] (1) overtime operation of plant, (2) inexperienced operators, (3) adverse climatic or atmospheric conditions, (4) destructive raw materials, (5) effect of fumes and granite dust and similar abrasive material and (6) use of equipment upon a type of work for which the equipment was not designed.

An allowance for accelerated depreciation will not be granted, however, unless it can be shown that maintenance did not compensate for the increased use and did not in fact arrest the accelerated depreciation which would have been caused by such excessive use.[152] Moreover, mere proof of abnormal use of property will not entitle you to an increased allowance. It must be affirmatively shown, through evidence submitted by experts, that the useful life of the property was shortened as the direct result of the factors which are urged as the basis for the allowance.[153] Moreover, in view of changes in methods which have been provided by the 1954 Code, an even greater degree of proof will probably be required where a claim of accelerated depreciation is made, although Congress has said that the liberalized methods are not intended to deprive a taxpayer of more rapid depreciation where the facts and circumstances warrant it.

Conditions may also develop which will have the result of extending the useful life of property. This may be due, for example, to a marked, prolonged period of inactivity of your plant[154] or to a technological improvement which results in reducing the corrosive influence of raw materials.[155] In such case, however, it must be remembered that normal obsolescence will probably continue at its usual rate so that only the factor of increase in the physical life of the asset may be considered in redetermining its useful life. Here again it must be affirmatively shown that the condition will have the direct result of extending the useful life of the property. In that event the unrecovered cost may be spread ratably over the newly determined remaining useful life.

The normal rate of depreciation used with respect to any asset contemplates that from time to time there will be minor deviations in actual depreciation sustained. It is expected that over the entire period of useful life, such variations from the norm will tend to balance or cancel themselves out. Therefore, adjustments should not be made unless accelerated or decelerated depreciation or an error in the rate or useful life is substantial.

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[150] *Leonard Refineries, Inc.*, footnote 141 above.

[151] *Estate of Clarence B. Eaton*, footnote 133 above; *Alvin Glass Hall*, 7 T.C. 1220 (1946); *Drayton Mills*, 19 B.T.A. 76 (1930); *Hyatt Roller Bearing Co.* v. *U.S.*, 43 F. 2d 1008, 9 AFTR 213 (Ct. Cls. 1930); *Camden Woolen Co.*, 12 B.T.A. 1277 (1928).

[152] *Estate of Clarence B. Eaton*, footnote 133 above.

[153] *Diamond Alkali Co.* v. *Heiner*, 39 F. 2d 645, 653, 8 AFTR 10571 (D.C.; W. D. Penn. 1930), modified in 60 F. 2d 505, 11 AFTR 777 and reversed on other grounds in *Heiner* v. *Diamond Alkali Co.*, 288 U.S. 502, 53 Sup. Ct. 413, 12 AFTR 4; *The Copifyer Lithograph Corp.*, 12 T.C. 728 (1949); *Harry Sherin*, 13 T.C. 221 (1949).

[154] *Mosler Safe Co.*, B.T.A. Memo Dec. September 9, 1942 (par. 42,501 Prentice-Hall Memorandum B.T.A.) reversed on rehearing (par. 43,456 Prentice-Hall Memorandum T.C.) following decision in *Virginian Hotel Corporation*, footnote 7, above.

[155] *Leonard Refineries, Inc.*, footnote 141 above.

13. How Shall a Lessee Take Depreciation?

We have previously noted that a lessee who makes improvements to leased property is entitled to recover the amount of his cost or investment in such improvements.[156] His cost may be amortized over the useful life of the improvement, provided that such useful life is less than the term of his lease; otherwise he may recover his cost by prorating it over the term of the lease. If the lease has a renewal clause, the cost is amortizable over the life of the original lease unless the facts show with reasonable certainty that the lease will be renewed. In such event it is amortizable over the life of the improvement or the combined terms, whichever is the shorter.[157] This rule is applicable even where the renewal clause provides that the property is to be valued as of the time of renewal and the rent thereafter based upon the new value.[158]

If the cost of the improvement is amortizable over the life of the lease and, prior to the end of the term, the lease is extended, the unrecovered cost must then be prorated over the remainder of the original term plus the newly extended period or until the end of the improvement's normal useful life, whichever is the shorter.[159] In the case of a tenant at will who makes improvements, his cost may be amortized over the life of the improvement.[160]

In any case in which it appears that the life of the improvement will be curtailed by reason of any of the factors which have been enumerated above, or where errors have been made in the base, rate, or useful life, adjustments may be made by the lessee in the same manner as in the case of the owner of property, in order that the lessee may recover his investment through depreciation allowances.

14. What Records Should Be Kept?

The maintenance of adequate depreciation records is a prime requisite for obtaining the maximum benefits of the statutory allowance. All that has been said to aid you in determining the correct basis, depreciation method, rate, and useful lives of your assets may fail to help you obtain the full deduction if your plant ledger is faulty. You should keep an adequate card index, looseleaf system, or other system in which are recorded the data and proof or source of proof respecting each item that enters into the computation of the allowable depreciation for every asset in your plant account.

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[156] See Sec. 3 and footnotes 24-29, inclusive, above.

[157] Reg. 118, Sec. 39.23(a)-10; *Alamo Broadcasting Co.*, 15 T.C. 534 (1950).

[158] *Hens & Kelly, Inc.*, 19 T.C. 305 (1952).

[159] T.D. 4957, 1939-2 C.B. 87; footnote 157 above.

[160] *Simmons Brick Co.*, 14 B.T.A. 878, 883 (1928); *Thatcher Medicine Co.*, 3 B.T.A. 154 (1925); *Wm. Scholes & Sons, Inc.*, 3 B.T.A. 598 (1926).

It is in your records that factual support must be found to substantiate the data entered upon the depreciation schedule of your tax return. Proof as to the cost or other basis of assets, for example, is generally most troublesome when depreciation cases are in litigation. Your records should show the date and source of acquisition and price paid for each asset, and these should also be properly identified and described. If the asset has a substituted basis, such record should show the same information respecting the predecessor. The record should also show a description of each addition or improvement to the asset and the date and cost thereof, and the same data regarding any retirement or other elimination from the asset. The amount of each annual credit to the reserve, based upon the rate or useful life employed, may be noted on the card or loose-leaf record; but where a control record is maintained, detailed postings are obviated. In this way you have a satisfactory office record of the cost or other basis of your assets, adjusted for additions or retirements and for annual depreciation allowances by years, and disclosing at a glance the remaining unrecovered cost and remaining useful lives of your assets. The Commissioner's determination respecting the amount of allowable depreciation is presumptively correct. In a great many tax cases the taxpayer is unable to present the facts properly on the issue in dispute for the sole reason that the necessary proof is lacking concerning matters which should appear in his records. As the result, the case is lost because of failure of proof alone. Therefore, it is urgent that you maintain a satisfactory plant ledger.

The correct handling of book entries which are concerned with depreciation is, of course, equally important. Some mention of the treatment to be given specific situations has previously been made in the discussion under Section 8. The following book entries should cover most phases of the subject of depreciation:

Asset account:

1. Charge the account with the cost or other basis of each asset acquired.
2. Credit the account with the cost or other basis of each asset disposed of through sale, retirement, abandonment, casualty, or otherwise.
3. Charge the account with the cost of each new replacement plus installation. Credit the account with the cost of each item or part replaced.[161]

Depreciation reserve account:

1. Credit the account with the annual depreciation (inclusive of obsolescence) allowed or allowable.
2. Charge the account with the full cost or other basis (adjusted for salvage) of normal retirements.
3. Charge the account with the amount of accrued depreciation and obsolescence with respect to each asset sold, transferred, or retired because of casualty or special obsolescence.

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[161] Bulletin "F," page 7. The cost of rehabilitation, as distinguished from betterments or improvements, may be charged directly to the reserve, leaving the capital or asset account undisturbed.

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30

How to Get Deductions for Bad Debts

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Those familiar with the Federal income tax law know the importance of conducting one's affairs in such a manner as to incur the least possible income tax liability. Two different methods of achieving a certain result may involve totally different tax liability. But once transactions have been carried to a conclusion, little can be done about the tax consequences. This is also true of bad debt deductions, all the more because bad debts are not expected at the time the debt is created. They are rather the result of a slow deterioration in one case, or an overnight casualty in another. It is therefore advisable that every transaction into which you enter, and through which you become a creditor, be so conducted that a bad debt deduction will be allowed if a loss is incurred.

Section 166 of the Internal Revenue Code 1954 (Sec. 23(k) of the 1939 Code) specifically provides that debts that become worthless within the taxable year constitute a proper deduction from your gross income. It further admits the use

Taxpayer Claiming Deduction	If Your Debt Is from	
	Unsecured Loans*	Securities†
Taxpayer other than a corporation		
Non-business debt	Short term capital loss, no partial loss allowed	Capital loss on the last day of the taxable year
Business debt	Bad debt	Same
Corporation other than a bank		
In general	Bad debt	Same
Debtor is 95 per cent-owned-affiliated corporation whose operating income for all years was more than 90 per cent of total gross income.	Bad debt	Bad debt, but no partial loss is allowed
Banks	Bad debt	Bad debt

* This category includes: unsecured loans or accounts receivable, notes, advances; also the amount remaining uncollectible after collateral has been applied against secured loans.

† In this group is included: securities, such as bonds, debentures, notes, or certificates with interest coupons or in registered form, but *not* shares of stock, or rights to subscribe to stock.

of a reserve for bad debts, at the discretion of the Commissioner. Under certain conditions, a debt recoverable only in part may be deducted in an amount not in excess of the part charged off within the taxable year. In other cases a bad debt may not be deducted as such for tax purposes. Check the quick guide on page 521 for the broad classifications as indicated.

Contributions for political purposes do not create a debt and consequently may not be claimed as a bad debt at any time. Section 271 of the 1954 Code (Section 23(k)(6) of the 1939 Code, enacted in 1951) specifically denies the deduction to all taxpayers other than a bank for any debts owed by a political party or by any National, State, or local committee of a political party or by any committee, association, or organization which accepts contributions or makes expenditures for the purpose of influencing or attempting to influence the election of Presidential or Vice-Presidential electors or of any individual whose name is presented for election of any Federal, State or local elective public office.

1. Points to Consider

In order to obtain a correct understanding of the provisions of the law, the various relationships representing indebtedness of one person to another are herein reviewed in the light of the Regulations and of some of the many decisions that have been rendered in specific cases, arranged as follows:

Section
When do you have a debt for bad debt purposes? 2
When do you have a worthless debt? 3
How to treat secured debts 4
  How endorsers and guarantors claim bad debts .... (a)
  How mortgagees claim bad debts .... (b)
How to get a deduction for worthless securities 5
How non-business bad debts are treated 6
What to do when you get a deduction for debts owed by affiliated corporations 7
What to do when you deduct for bad debts owed by relatives and friends 8
When a stockholder-creditor deducts for bad debts 9
How to use a reserve for bad debts 10
How to treat recoveries of bad debts 11
How other sections of the tax law affect bad debts 12

2. When Do You Have a Debt for Bad Debt Purposes?

A debt has been defined as "that which is due from one person to another, whether money, goods, or services; that which one person is bound to pay to another, or to perform for his benefit."[1] It has also been defined to mean "every claim and demand upon which a judgment for a sum of money, or directing the payment of money, could be recovered in an action."[2]

Thus you must establish a valid and enforceable debt. If goods are shipped or services have been rendered, there should be proof of order, delivery, and acceptance. If money is lent, there should be obtained from the debtor a definite promise to repay, preferably in writing.

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[1] Definition quoted in *Henry*, B.T.A. 1089 (1927).

[2] *Ibid.*, quoting *Words and Phrases*, 1st Series, Vol. 2, 1864-66, Minneapolis: West Publishing Co., 1940.

There must be a reasonable expectancy on your part that the indebtedness to you will be satisfied.[3] A solvent business man may be expected to pay his bills when due. A borrowing individual, however, may be scrutinized as to his financial standing, his earning power, his health and age, to determine the probability of repayment. If a debt is acquired it must have a value at date of acquisition and cannot represent "a mere shadow of a debt."[4]

Certain debts are not regarded as bad debts when they prove uncollectible, unless the amounts were previously included in taxable income: for example, unpaid salary,[5] rent, and interest.

Beware of lending money under such indefinite conditions that the loans appear to be gifts. An advance to a company that was in financial difficulties, evidenced by a note subject to contingencies rendering it non-negotiable and in fact unenforceable, was held to be a contingent gift and not deductible as a bad debt.[6] Loans made to individuals for non-business purposes, especially to friends or relatives, should be made under enforceable conditions in order not to lose a tax deduction in case of hopeless default of the obligor.

A classification of a claim as "debt" is not acceptable where the known facts do not lend support to such contention. An amount due from a building and loan association upon notice of intention to withdraw did not change the investment into a debt.[7] The charging to accounts receivable of the development cost of a patent did not create a debt.[8] Money advanced in a venture in which taxpayers were to share in the profits was not in fact a loan.[9]

Once the debtor-creditor relationship has been established it becomes your duty as creditor to make every possible effort to collect.[9a] It does not matter how old a debt is that you assert is worthless, as long as you, the creditor, did not relinquish your position as such, and as long as the debt remained enforceable and collectible until the first day of the taxable year in which the deduction is claimed.[10] Here again, proof for having made demands upon the debtor to collect in whole or in part is necessary. Although it is not mandatory to submit such proof as copies of collection letters and the replies thereto in writing, such evidence is generally more readily accepted than oral testimony. This is especially true in the case of bad debts originating in loans made to individuals.

Disinclination to force payment may be taken as relinquishment of the right to claim the obligation as a bad debt deduction.[11] If, in a conflict of interests, the demand for satisfaction of the debt is subordinated, the creditor may forfeit his right to claim a bad debt deduction.[12]

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[3] *Houston Chronicle Publ. Co.*, 3 T.C. 1233 (1944); *Dallas Rupe & Son*, 20 T.C. 46.

[4] *McGoldrick* (1942), par. 42,065 Prentice-Hall Memorandum B.T.A.

[5] *Kuch et al.* (1942), par. 42,151 Prentice-Hall Memorandum B.T.A.

[6] *American Factors, Limited* v. *Kanne* (U.S.D.C. Hawaii), 100 Fed. Supp. 329 (1951), affirming in part and reversing in part on remand, CA-9, 76 Supp. 133 (1947) AFTR 1338.

[7] *Goodman* v. *Helvering* (2 Cir. 1940), 115 F. 2d 242, 25 AFTR 962.

[8] *Coney & Parker Co.*, 2 B.T.A. 400 (1925).

[9] *M. T. Davis*, 46 B.T.A. 663 (1942) (acq.); *John W. Sluss*, Tax Court memorandum opinion, entered April 27, 1951, Docket No. 27,064.

[9a] *Runyan*, 8 T.C. 350 (1947) (acq.). However, a reasonable effort to collect is not a requisite for a deduction: *Smyth* v. *Barneson* (C.A.-9), 181 Fed. (2nd) 143 (1950); *Reuter*, Tax Court memorandum opinion, entered March 30, 1951, Docket Nos. 22,658, 23,838.

[10] *Castle* (1947), par. 47,205 Prentice-Hall Memorandum T.C.

Suppose that in your efforts to collect a debt, a compromise is reached whereby the debtor makes a partial settlement. If he has no assets to meet the remainder of his obligations, a bad debt deduction will be allowed. But if the entire amount could have been collected by suit, it may be that no amount will be allowed.[13] Business compromises most often are not the result of the debtor's inability to pay, but rather of a contested claim. The losses attributable to such compromises should be taken as business losses and not as bad debts.[14]

3. When Do You Have a Worthless Debt?

Mere opinion by the taxpayer is not sufficient proof that a debt has lost its value.[15] In order to claim a bad debt, you must convince the Commissioner that it has lost its value.

Default of payment of principal or interest, by itself, is insufficient evidence of worthlessness.[16] Financial embarrassment does not render the debt valueless, if there is a hope that a good financial standing might be restored by prospective additional capital.[17] Even dissolution of a business by itself may be insufficient proof.[18] However, if a corporation discontinues business, abandons its charter, and has no assets, its obligations are worthless.[19] If a debtor disappears or leaves the country without arranging to settle his obligations, his debts are regarded as worthless.[20] Death of the debtor merely transfers the obligation to his estate. But if there are no assets in the estate, the debt is worthless.[21]

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[11] *Krack,* 1 B.T.A. 1119, Dec. 434 (1925); *Ellisberg,* 9 T.C. 463 (1947); *Matthews,* 8 T.C. 1313 (1947).

[12] In *Bennet,* 20 B.T.A. 171 (1930). Mills Bennet's relations to the Bennet Petroleum Corporation were those of a creditor and also those of a stockholder, and the rights appertaining to the former status were superior to the rights of the latter. As a creditor he was entitled to have the entire assets of the corporation subject to the payment of his claim before he could participate in these assets as a stockholder. Under these circumstances, he was not permitted to charge off as worthless and deduct from his income his superior claim, and retain the inferior one.

[13] O.D. 297, 1 C.B. 1126; *Annie B. Smith,* Tax Court memorandum (February 12, 1953).

[14] *McCabe Lathe & Machinery Co.,* 9 B.T.A. 1137 (1928).

[15] *Rubin,* 9 B.T.A. 1183 (1928); *Akron Auto Garage Co.,* 1 B.T.A. 1066 (1925); *Victor Steinegger* v. *Stewart* (D.C. Arizona), Civ-1402 Phx. No. Civ-1403.

[16] *Coon Valley State Bank,* 13 B.T.A. 132 (1928).

[17] *Smythe Co.,* 4 B.T.A. 327 (1926).

[18] *Leicht* v. *Commissioner* (8 Cir. 1943), 137 F. 2d 433, 31 AFTR 403.

[19] *Hallam,* 2 B.T.A. 1220 (1925) (acq.).

[20] *Thos. J. Avery* v. *Commissioner* (5 Cir. 1927), 22 F. 2d 6, 6 AFTR 7019; *Pabst* v. *Lucas* (D.C. Cir. 1930), 36 F. 2d 614, 8 AFTR 9897, cert. den. 281 U.S. 741; *Barry,* 2 B.T.A. 1095 (1925) (acq.): *T. P. Jones & Co.,* 2 B.T.A. 1218 (1925) (acq.); *Linn,* 4 B.T.A. 76, Dec. 1443 (1926) (acq.); *Jones Lumber Co.,* 5 B.T.A. 1159 (1927) (acq.); *Burgieres Co.; Ltd.,* 12 B.T.A. 879 (1928) (acq.); *Barnette,* 16 B.T.A. 1390 (1929) (acq.); *Brickell,* 17 B.T.A. 711 (1929) (acq.); *Standard Warehouse Co.* (1941), par. 41,255 Prentice-Hall Memorandum B.T.A.; *Crinnion* (1941), par. 41,375 Prentice-Hall Memorandum B.T.A.; *Gross* (1947), par. 47,263 Prentice-Hall Memorandum T.C.

[21] *Ellery,* 4 T.C. 407 (1944) (acq.); *Dahlke* (1949), par. 49,241 Prentice-Hall Memorandum T.C. Where taxpayer, informed that decedent had few assets did not investigate the possibility of collection or file a claim against the estate, deduction was denied. *Roberts* (1948), par. 48,165 Prentice-Hall Memorandum T.C.; *David E. Kahn,* Memorandum T.C. (April 8, 1953).

Formerly, a bad debt was deductible only at the time it was ascertained to be worthless and written off. For taxable years beginning after December 31, 1938, however, the Revenue Act of 1942 provided that the debts are deductible when they become worthless. Thus you are required to prove not only that a debt is bad, but that it became bad in the particular year for which you claim the deduction.

If your efforts to collect the amount due you remain unsuccessful, there will invariably occur a certain identifiable event that will make you realize that the debt is uncollectible, despite all your efforts. The time of that event fixes the time for deduction. You have no right to elect the year in which you deduct a worthless debt.[22] There are numerous cases on record where a debtor became insolvent or the uncollectibility of the debt became known in a prior year, and where the bad debt deduction was consequently denied in a subsequent year.[23]

When a business debt becomes partially worthless, you may deduct the amount that has become worthless from your income of the taxable year to the extent that you charge it off on your books.[24] But you need not deduct for partial worthlessness whenever it develops; you may wait and take the entire deduction when the debt becomes wholly worthless.[25] If you should sell a debt that has depreciated in value for less than the amount due, you are not entitled to a bad debt deduction for the difference but may have a capital loss.[26]

4. How to Treat Secured Debts

Unless the creditor has a certainty that the debt will be paid when due, either because the debtor's credit is well established or because of an appraisal by the creditor of the size of the obligation and the terms involved in satisfying it, the creditor looks for some protection. This protection takes many forms.

a. How endorsers and guarantors claim bad debts. A common form of security is the endorsement or the guaranty of a third party, who is usually financially stronger. If you obtain such an added assurance from the debtor and the debtor is then unable to pay when the obligation becomes due, your duty is immediately to request satisfaction of the debt from the endorser or guarantor in order to protect your right of enforcement. Thus, although you have enjoyed added protection from the guaranty or endorsement, you will have added burden of proof in a bad debt deduction that collection was impossible from both the primary obligor and the endorser or guarantor.

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[22] *Frank, Nathan*, 13 B.T.A. 964 (1928). Although this decision was rendered under prior law, the denial of the right to elect the year of deduction is well established.

[23] A few recent cases are: *Sailer et al.* (1948), par. 48,085 Prentice-Hall Memorandum T.C.; *Kepler* (1948), par. 48,087 Prentice-Hall Memorandum T.C.; *Home Builders Lumber Co.* v. *Commissioner* (5 Cir. 1948), 166 F. 2d 1009, 36 AFTR 730; *Hahnel Bros. Co.* v. *Clanson* (DC) 74 F. Supp. 532 (1948), 36 AFTR 550; *Pierce*, Tax Court memorandum opinion, entered October 25, 1949, Docket No. 18871; *Vars*, Tax Court memorandum opinion, entered January 24, 1950 Docket No. 21,771; *Posey et al.* Tax Court memorandum opinion, entered April 18, 1951, Docket Nos. 27,006, 27,005, 27,004 (taxpayer's appeal to C.A.-3 dismissed January 25, 1952); *Joseph M. Gwinn Jr.*, Tax Court memorandum opinion, entered December 26, 1951, Docket Nos. 25,042 to 25,045; *H. Paul Prigg*, Tax Court memorandum opinion, entered September 8, 1952, Docket No. 30,889.

[24] Special ruling, letter to Van Vorst, Siegel & Smith, 25 Broad St., New York, N.Y., dated July 31, 1944, symbols IT:P:T:2-JD-3; *Samuel S. Denton Est.*, Memorandum T.C. July 31, 1952.

[25] *E. Richard Meinig Co.*, 9 T.C. 976 (1947); *Pantex Oil Corp.*, Memorandum T.C. Dec. 19, 1949; *Samuel S. Denton Est.*, Memorandum T.C. July 31, 1952; *Feltex Corp.*, Memorandum T.C. April 9, 1953.

[26] *Levy* v. *Commissioner*, 46 B.T.A. 423 (1942), (2 Cir. 1942) 131 F. 2d 544, cert. den. 318 U.S. 780 (1943); *Holmes-Darst Coal Corp.*, Memorandum T.C. Feb. 5, 1952; *John F. B. Mitchell* v. *Commissioner*, 13 T.C. 368 (1949), (2 Cir. 1951) 187 F. 2 706.

But suppose you are the endorser or guarantor and are called upon to make good your promise to protect the creditor from harm. You acquire a bad debt but can claim a deduction only if you actually make payment[27] *and* (*not* or), in addition, if your claim against the primary obligor is worthless.[28] The two conditions are independent of each other, but both must be met for a bad debt deduction. It might be that you are required to make good a guaranty in one year when there is still a possibility of collecting from the debtor. You will not be permitted to deduct a bad debt until your claim against the primary obligor has become definitely worthless. On the other hand, deduction as a bad debt may be allowed immediately upon payment of the guaranty because of the insolvency of the debtor at that time. But if you should pay such a guaranty in installments, then a bad debt deduction arises only as payments are made.[29] It is in such instances possible to maneuver the bad debt deduction into a future taxable year, provided the original creditor is willing to wait. Another possibility: If the funds for satisfying the guaranty should be lacking but a bad debt deduction in the full amount is desirable, the necessary funds could be borrowed to discharge the guaranty.

Section 166(f) of the 1954 Code provides that a payment by a taxpayer (other than a corporation) in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of a noncorporate indebtedness results immediately in a business bad debt provided (1) that the proceeds of the indebtedness had been used in the trade or business of the borrower and (2) that the indebtedness (without regard to the guaranty, endorsement, or indemnity) was worthless at the time of such payment.

It should be borne in mind that there must be a legal obligation to satisfy the guaranty. The making good voluntarily of another man's debt makes such action a gift, not a bad debt. Furthermore, if a guarantor, after claiming a bad debt deduction, makes further guaranties for the same debtor, he may nullify his claim that the old account was uncollectible.[30]

A co-guarantor may sometimes have to pay the entire debt. You can only deduct your pro-rata share of the debt. But if the other guarantors are insolvent or you cannot collect from them, you have a bad debt for the balance.[31]

(b) How mortgagees claim bad debts. Another way of securing a debt is the taking of a mortgage on or a pledge of property. If the debtor defaults, the creditor may lawfully dispose of the property and apply the proceeds against the indebtedness. If the proceeds should be larger than the debt, the debt would be fully satisfied and the excess turned over to the debtor. More frequently in such instances, however, the proceeds from the property will not cover the debt, in which case the unsatisfied portion, if uncollectible otherwise, becomes deductible as a bad debt.[32] The uncollectibility of the remainder of the debt must be proved by showing that legal action to collect it resulted in no recovery, or that such action would have been in all probability useless.[33]

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[27] *Shiman* v. *Commissioner* (2 Cir. 1932), 60 F. 2d 65, 11 AFTR 700; *Bemb,* 5 T.C. 1335 (1945); *Leslie,* 6 T.C. 488 (1946); *Oritz* 42 B.T.A. 173 (1940) (acq.); *Gray, et al.* Tax Court memorandum opinion, entered August 10, 1949, Docket Nos. 14,300, 14,301.

[28] I.T. 2025, III-1 C.B. 166; *Humphrey* (1946), par. 46,004 Prentice-Hall Memorandum T.C.; *Rubin,* 9 B.T.A. 1183 (1928); *Bickley,* 1 B.T.A. 544 (1925) (acq.).

[29] *Roberts,* 36 B.T.A. 549 (1937) (acq.).

[30] *Coburn,* 16 B.T.A. 1334 (1929).

[31] *Ritter,* (1946) par. 46,237 Prentice-Hall Memorandum T.C., affirmed per curiam, (6 Cir. 1947) 163 F. 2d 1019, 36 AFTR 215.

If part of the collateral is lost, as for instance by the death of some livestock covered by the chattel mortgage securing a note, the loss is not conclusive evidence of the worthlessness of any part of the debt, because the loss can be determined only after the final disposition of the collateral.[34]

If you, as creditor, acquire the property either directly or through competitive bidding, the fair value of the property governs whether you had a gain or loss. The fair market value is presumed to be the amount for which the property is bid in by you, in the absence of clear and convincing proof to the contrary. After applying the fair market value of the property against the debt, you must attempt to collect the remainder. Failing in this, you may at once deduct it as a bad debt. If you subsequently sell the property so acquired, the basis for determining gain or loss is the fair market value on the date of acquisition.[35] The later sale will not be related back to the debt, but stands on its own merits, both as to whether it is an ordinary sale or a sale of a capital asset, and as to the amount of gain or loss.

Delinquent taxes paid by you on the property are treated in different ways according to the time of payment. If paid prior to the foreclosure, they represent additional amounts lent to the debtor. If paid after the foreclosure, they represent additional cost of the property. Such delinquent taxes are not deductible as taxes or otherwise.[36] However, if you make advances to the debtor to protect a lien on the property, such advances are loans,[37] deductible when the debt goes bad.

In the acquisition of property intended to satisfy all or a part of a debt, care should be taken that the method chosen establishes an identifiable event or a closed transaction for tax purposes, wherein a loss on the debt can be determined.[38] The establishment of a fair market value of the property is also important to the establishment of the loss, else the deduction of a loss may be denied.[39] Where a taxpayer corporation took over the business of its debtor, a bad debt deduction consisted of the difference between the amount of the debt and the net amount of realizable assets over liabilities.[40]

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[32] Reg. 118, Sec. 39.23(k)-3.

[33] O.D. 687, 3 C.B. 166. Where the debtor whose property was insufficient to meet the judgment disappeared, the deduction of the balance due was allowed. *Dalton*, 2 B.T.A. 615 (acq.); *Vancoh Realty Company*, 33 B.T.A. 918.

[34] A.R.R. 3385, II-2 C.B. 137.

[35] Reg. 118, Sec. 39.23(k)-3; *Brawner Est.*, 36 B.T.A. 884 (1937) (acq.).

[36] *John Hancock Mutual Life Ins. Co.*, 10 B.T.A. 736 (1928); *Schieffelin Est.*, 44 B.T.A. 137 (1941) (acq.); I.T. 1611, II-1 C.B. 87.

[37] *Gaba* (1945), par. 45,288 Prentice-Hall Memorandum T.C.; *Lucia C. Ewing* v. *Higgins* (D.C. Southern of N.Y.), Civ. 43-67, June 19, 1952.

[38] *Hardwick* (1947), par. 47,060 Prentice-Hall Memorandum T.C.

[39] *Perot's Sons Malting Co.*, 1 B.T.A. 562 (1925); *Commissioner* v. *West Production Co.* (5 Cir. 1941), 121 F. 2d 9, 27 AFTR 618, cert. den. 314 U.S. 682; *Malden Trust Co.* v. *Commissioner* (1 Cir. 1940), 110 F. 2d 751, 24 AFTR 778.

[40] *Kellogg-Mackay Co.*, 20 B.T.A. 635 (1930) (non-acq.).

5. Deduction for Worthless Securities

Although under the Internal Revenue Code of 1954, deductions with respect to debts evidenced by a security are covered in the "Loss" section of the law rather than in the "Bad Debts" section, reference is made here to losses arising from worthlessness of "a bond, debenture, note, or certificate, or other evidence of indebtedness issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form." [41]

A security in the hand of any taxpayer other than a bank constitutes a capital asset. Upon its becoming wholly worthless, the loss is considered as being sustained from its sale or exchange on the last day of the taxable year, irrespective of the time during the year when such security actually became worthless. The loss is consequently not classified as a bad debt, and a deduction for partial worthlessness is not allowable.[42]

A bank may deduct as a bad debt a security that has become worthless in whole or in part.[43]

By a bank is meant, according to Section 581 of the 1954 Code (Section 104(a) of the 1939 Code), "a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under Section 11(k) of the Federal Reserve Act (38 Stat. 262; U.S.C. 248(k)) and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association."

The worthlessness of a bond must be substantiated by facts and circumstances just as any other claim for a bad debt deduction is.[44] A specific order by a supervising Federal or state authority to charge off a debt in whole or in part is now presumed to be conclusive evidence of the debt's worthlessness to the extent of the charge off.[45] (This refers to banks only!) However, mere depreciation in market value of a bond does not warrant a deduction if there is no indication that the bond is in default or would not be paid at maturity.[46] Default in payment of principal and interest is not conclusive of the worthlessness of a bond.[47]

Be careful to differentiate between a secured debt (Section 2) and a security (Section 3). When the debtor who has pledged a security becomes insolvent, the creditor often simply keeps the security in the hope that it might appreciate in value and thus reduce his loss. This is dangerous taxwise, for there are two distinguishable transactions involved, resulting in gain or loss. First, the difference between the debt and the fair market value of the security at the date of insolvency of the debtor represents a bad debt loss, or (rarely) taxable income. The fair market value of the security becomes the basis of the capital asset thus acquired, and when this is sold, a capital gain or loss results. It is recognized at 50 per cent if the asset had been held more than six months.

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[41] Definition is taken directly from the Code: 1954 IRC Sec. 165(g)(2)(c); substantially the same as 1939 IRC Sec. 23(k)(3).

[42] 1954 IRC Sec. 165(g)(1); 1939 IRC Sec. 23(k)(2); Reg. 118, Sec. 39.23(k)-4.

[43] 1954 IRC Sec. 582(a); 1939 IRC Sec. 23(k).

[44] *Bank of Watertown,* 1 B.T.A. 1171 (1925); *Beebe Estate,* 15 B.T.A. 1022 (1929); *Brodnax,* 19 B.T.A. 223 (1930); *Leckie,* 37 B.T.A. 252 (1938); *World Supply Co.,* 41 B.T.A. 965 (1940).

[45] Reg. 118, Sec. 39.23(k)-1(e).

[46] *Securities Allied Corp.* v. *Commissioner* (2 Cir. 1938), 95 F. 2d 384, 20 AFTR 1111.

[47] *Merrill Trust Co.,* 21 B.T.A. 1395 (1931).

6. How Non-business Bad Debts Are Treated

The term "non-business debt" means a debt other than a debt evidenced by a "security" and other than a debt which was created or acquired (as the case may be) in connection with the taxpayer's trade or business[48] or the loss from the worthlessness of which is incurred in the taxpayer's trade or business.[49] If a taxpayer other than a corporation, suffers a loss from a non-business debt's becoming totally worthless, the loss is considered a short-term capital loss. All the limitations provided in Section 1222 with respect to gains and losses from the sale and exchange of capital assets apply. No deduction is allowed for a partial worthlessness of a non-business debt. All debts of a corporation are business debts.

This section of the law is not concerned with the question of whether a loss was suffered. That question must be answered by the general rules discussed in other sections of this chapter. The section here concerns the character of the debt, which can be determined from the answer to the question: Is the debt a proximate one in the creditor's (not a corporation) business? If the answer is affirmative, a bad debt deduction is in order. If not, it is treated as a short-term capital loss.[50]

Under the regulations of the 1939 Code, which is applicable to taxable years beginning before 1954 or ending before August 17, 1954, the character of a debt was determined at the time of its becoming worthless, the circumstances attending the creation or its subsequent acquisition by the taxpayer, not being controlling. Nor had the use to which borrowed funds were put by the recipient any bearing on the character of the debt.[51]

Because of the limitation on capital losses, a claim of a deduction for a non-business bad debt by a non-corporate taxpayer may not be advantageous to him taxwise. You should, for this reason, review carefully all facts and circumstances attending your loss. Determine whether you can classify it as a casualty loss or as a loss arising out of a transaction entered into for profit. Such losses can be deducted in full. To support such a claim, you must prove either that no debtor-creditor relationship existed, or that the default was caused by factors other than financial inability to pay.

A few examples of instances in which the loss was deductible as such, rather than as a bad debt: Payment in advance for goods that were never delivered may result in a loss, not necessarily when paid, but when proved by events.[52] Settlement of a disputed claim for less than its face value, if your motive for such settlement is avoidance of costly litigation or the furtherance of your own financial interest, does not result in a bad debt or a gift.[53] Payments made under a guaranty after dissolution of a corporation debtor do not constitute a bad debt, because a creditor-debtor relationship could not arise at time of payment (corporation being out of existence).[54] Embezzlement losses are casualty losses. You may deduct all your loss not compensated by insurance.[55] Confiscation of a receivable by a foreign government is an ordinary loss, since failure to pay is not caused by the insolvency of the debtor.[56]

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[48] 1954 IRC Sec. 166(d)(2)(A)—a new provision in 1954 Code.

[49] 1954 IRC Sec. 166(d)(2)(B); 1939 IRC Sec. 23(k)(4).

[50] Throughout this article references are made to the determination of whether and when a debt became worthless, regardless of whether it was a business or a nonbusiness bad debt. It should be understood that any nonbusiness bad debt referred to anywhere in this article is also subject to this paragraph.

[51] Reg. 118, Sec. 39.23(k)-6.

[52] *Llewellyn* v. *Electric Reduction Co.*, 275 U.S. 243, 6 AFTR 7074 (1927).

7. Deductions for Debts Owed by Affiliated Corporations

A special rule applies to losses on "securities" of affiliated corporations. Under Section 165(g) of the 1954 Code, a corporation is

> "deemed to be affiliated with the taxpayer [a domestic corporation] only if
>
> (A) At least 95 per centum of each class of its stock is owned directly by the taxpayer; and
>
> (B) More than 90 per cent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities."

Under the rule, the securities of the affiliated corporation are not considered capital assets. Consequently, they are deductible upon becoming wholly worthless as bad debts. But they are not deductible because they are partially bad. Similarly, losses in open accounts and notes of affiliated corporations that are not included in the definition of "securities" as defined in this article are deductible as bad debts when they become worthless. Such losses occur at the time when the parent corporation takes over the subsidiary's assets in settlement of advances,[57] or when the parent dissolves the wholly-owned subsidiary and assumes its liabilities, taking over its assets as payment in part.[58] Worthlessness must be definite and complete. The reduction of accounts receivable to an estimated value is not deductible in such instances.[59]

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[53] *Charles S. Guggenheimer*, 8 T.C. 789 (1947) (acq.); *First National Bank of Durant, Oklahoma*, 6 B.T.A. 545 (1927) (acq.); *H. C. Thorman* (1949), par. 49,176 Prentice-Hall Memorandum T.C.

However, in *D'Alonzo*, Tax Court memorandum opinion, entered August 31, 1951, Docket 21,320, it was held that Code sections 23(k) and 23(e) are mutually exclusive.

[54] *Abraham Greenspon*, 8 T.C. 431 (1947) (acq.); *Hanna*, Tax Court memorandum opinion, entered June 6, 1951, Docket Nos. 25,706, 25,707.

[55] *Parker Wire Goods Co.*, 8 B.T.A. 542 (1927) (acq.).

[56] *Hector Fezandie*, 12 B.T.A. 1325 (1928); *Emil Stern*, 5 B.T.A. 89 (1926) (acq.).

[57] *Hill Stores, Inc.*, 44 B.T.A. 1182 (1941) (acq.); *Sturtevant Co.*, 47 B.T.A. 464 (1942) (acq.).

[58] *Glenmore Distilleries Co., Inc.*, 47 B.T.A. 213 (1942) (acq.); *Glenn* v. *Courier-Journal Job Printing Co.* (6 Cir. 1942), 127 F. 2d 820, 29 AFTR 415.

[59] *Quadrica Mfg. Co.*, 2 B.T.A. 1119 (1925).

If for any taxable year a consolidated return has been filed, there is deductible only that part of the bad debt that exceeds the subsidiary's loss which had offset the parent corporation's income on the consolidated returns.[60] Where the losses of the subsidiary that are reflected in prior years in consolidated returns exceed the loss experienced on liquidation, no bad debt deduction can be allowed.[61]

In the event of the liquidation of a subsidiary and a bad debt claim by the parent, it must be shown that the advances made to the subsidiary became bona fide obligations of the subsidiary and not contributions to the capital of the subsidiary. Advances made for the purpose of expanding plant and facilities, for instance, may be regarded as a part of the stock investment, with the consequence that a resulting loss would be a capital loss. Furthermore, the liquidation must be in such a form that it does not fall under Section 332 of the 1954 Code (Section 112(b)(6) of the 1939 Code).

8. Debts Owed by Relatives and Friends

Relationship of or friendship between the creditor and debtor does not invalidate an otherwise justifiable bad debt deduction. You must prove to the satisfaction of the Commissioner, however, that a debt actually existed and that no gift was involved.[62] The circumstances of the transactions and the purpose of the loan may be indicative of the intention of the parties. The expectation of repayment by the creditor is considered as well as the recognition of the obligation as such by the debtor.[63] Loans to relatives for business purposes, made and enforced in a businesslike manner, are deductible when they become worthless.[64] But further advances to assist the relative to discharge his obligations to his creditors and wind up his business have been held to be gifts.[65]

The arrangements made between a parent and child are subject to special scrutiny to overcome a presumption that a gift is involved. Notes given as security and provisions for payment[66] and careful bookkeeping of an open account over a number of years[67] have successfully supported the contention that a debt rather than a gift was involved. To the contrary, loans to the child for investment purposes[68] and a guaranty of the child's margin account with a stock broker[69] have been held to be gifts.

Leniency toward the related debtor may result in a disallowance of a bad debt. Advances to a broker evidenced by promissory notes could not be claimed as bad debts in absence of evidence as to what efforts had been made to collect.[70] Where the debt might have been paid if the family relationship had been ignored, the claim for a bad debt will not be allowed.[71]

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[60] *Katzinger Co.* v. *Commissioner* (7 Cir. 1942), 129 F. 2d 74, 29 AFTR 783.

[61] *Ilfeld Company* v. *Hernandez*, 292 U.S. 62, 13 AFTR 881 (1934); *Commissioner* v. *Emerson Carey Fibre Products Co.*, 70 F. 2d 990, 14 AFTR 233 (1934).

[62] *Moore, Edward H.*, 22 B.T.A. 366 (1931), appeal dismissed, 59 F. 2d 1069, 11 AFTR 674; *Bernheim* (1946), par. 46,026 Prentice-Hall Memorandum T.C.; *Erdman* (1946), par. 46,038 Prentice-Hall Memorandum T.C.

[63] *Weitzner*, 12 B.T.A. 724 (1928); *Jones, Ezra H.*, 13 B.T.A. 1271 (1928).

[64] *Westenhaver* (1944), par. 44,029 Prentice-Hall Memorandum T.C.

[65] *Baumann*, 8 B.T.A. 107 (1927) (acq.).

[66] *Fleitmann*, 22 B.T.A. 1291 (1931) (non acq.); *Hetherington* 20 B.T.A. 806 (1930) (acq.).

[67] *Ames* (1946), par. 46,036 Prentice-Hall Memorandum T.C.

[68] *Montgomery* v. *U.S.* (Ct. Cls.) 23 F. Supp. 130, 21 AFTR 244 (1938) cert. den. 307 U.S. 632.

[69] *Hoyt* v. *Commissioner* (2 Cir. 1944), 145 F. 2d 634, 33 AFTR 103.

9. When a Stockholder-Creditor Deducts for Bad Debts

The double relationship of a stockholder-creditor to his corporation must first of all be kept distinguishable in order to determine separately the amount owed to the stockholder by the corporation. If investment and advances are not separated, no deduction of any part as bad debt may be expected.[72] But the holding of stock by a creditor does not bar a bad debt deduction if all the incidental requirements are otherwise present.

Advances must be made with the expectation of repayment.[73] It is immaterial whether they are made on open account[74] or evidenced by notes. Advances may be made even proportionally to stockownership.[75] The intention largely governs whether or not a loan was intended, even though the loan may be financially indefensible.[76] Advances made with the provision that they be repaid in cash or, if the corporation were able to raise additional capital, in stock, became deductible as bad debts when the corporation was unable to raise the capital and went into bankruptcy.[77]

If the stockholder-creditors never expect to be reimbursed, their advances constitute additional contributions to capital, even though they received bonds or notes as evidence.[78] Advances by the sole stockholder to his corporation, which was in financial difficulties, were capital investments rather than loans.[79] The taxpayer's claim as creditor has preference over his claim as stockholder. He may not apply any part of an amount received in liquidation toward retirement of his stock without having first satisfied in full the debt owed him.[80]

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[70] *Hutchinson,* 11 B.T.A. 789 (1928); also other similar decisions: *Marion et ux.* (1947), par. 47,315 Prentice-Hall Memorandum T.C.; *Griffiths* v. *Commissioner* (7 Cir. 1934), 70 F. 2d 946, 14 AFTR 225; *Thom* v. *Burnet* (CA of DC 1932), 55 F. 2d 1039, 10 AFTR 1238; *Hayes,* 17 B.T.A. 86 (1929); *Bowser* (1948), par. 48,137 Prentice-Hall Memorandum T.C.; *Thomson,* 17 B.T.A. 127 (1929).

[71] *Nathan H. Gordon Corp.* 2 T.C. 571 (1943), Commissioner's appeal to 1st Cir. dismissed (nolle prosequi), January 31, 1944; *Fitzgerald* (1945), par. 45,228 Prentice-Hall Memorandum T.C.

[72] *Cohen* v. *Commissioner* (2 Cir. 1945), 148 F. 2d 336, 33 AFTR 939; *Gano* 19 B.T.A. 518 (1930); *Rosenberg* (1946), par. 46,058 Prentice-Hall Memorandum T.C.

[73] *Jobst* v. *U.S.* (DC-Southern Illinois, Northern Division) Civil Action No. P-70, filed March 10, 1941, 29 AFTR 1348; *Ives* 5 B.T.A. 934 (1936) (acq.); *Richardson* (1943), par. 43,030 Prentice-Hall Memorandum T.C.

[74] *Selden* v. *Heiner* (DC), 12 F. 2d 474 (1926), 5 AFTR 5963; *Campbell et al.,* 11 T.C. 510 (1948); *Ethel S. White* (1947), par. 47,262 Prentice-Hall Memorandum T.C.

[75] *Portuguese-American Tin Co.* (1943), par. 43,287 Prentice-Hall Memorandum T.C.

[76] *Ewing* (1946), par. 46,235 Prentice-Hall Memorandum T.C.; *C. Walter McCarthy, Jr., et al.* v. *Cripe* (D.C. Southern Indiana), No. Civil 2343, filed May 22, 1952; *Alma Spreckels,* Tax Court memorandum opinion, entered December 27, 1949, Docket No. 5741.

[77] *Conners* (1943), par. 43,352 Prentice-Hall Memorandum T.C.

[78] *American Cigar Co.* v. *Commissioner* (2 Cir. 1933), 66 F. 2d 425, 12 AFTR 1268, cert. den. 290 U.S. 699; *Isidor Dobkin* v. *Com.* (CA-2), 192 Fed. (2nd) 392 (1951); *Wallace L. Chesshire,* Tax Court memorandum opinion, entered February 19, 1952, Docket 30,969.

[79] *Van Clief* v. *Helvering* (CA of DC 1943), 135 F. 2d 254, 30 AFTR 1417.

[80] *W. D. Haden Co.* v. *Commissioner* (5 Cir. 1948), 165 F. 2d 588, 36 AFTR 670.

10. How to Use a Reserve for Bad Debts

In the discretion of the Commissioner, taxpayers may be permitted to establish a reserve method of treating bad debts rather than charge off specific bad debts each year. A change from one method to the other also requires the prior approval of the Commissioner.

The use of the reserve method is limited to merchants, manufacturers, and other taxpayers using the accrual basis of accounting. It cannot be used by cash basis taxpayers for the reason that they do not report income until collected, and as a consequence ordinarily have no bad debts. A dealer in personal property on the installment basis may also use the reserve method of accounting for bad debts.[81] Separate accounts must be kept, however, for the reserve relating to installment sales and for reserves relating to other accounts. The reasonableness of an addition to a reserve for bad debts with respect to installment sales depends upon the total amount of the capital portion of such accounts outstanding at the close of the taxable year, the then balance in the reserve account, and the experience of the dealer in respect to the installment accounts. Mimeograph 6209, issued by the Internal Revenue Service on December 8, 1947, prescribes procedure and methods for setting up and maintaining bad debt reserves in the case of banks, loan companies, and finance companies, even though their books are kept on the cash basis.[82]

The option to adopt the reserve method was first granted for the year 1921. Taxpayers then in business, in fact, made on their tax return an election of the method they wanted to use.[83] Taxpayers who took no bad debt deduction on their 1921 return, and those who came into existence in later years, make an election when they first claim a specific bad debt or an addition to a reserve.[84] If the books of account make use of the reserve method, but the income tax return claims actual bad debts as deductions, a change to the reserve method for tax purposes in later years may be made only by authorization of the Commissioner.

Additions to the reserve for bad debts should be reasonable and should reflect actual experience. Additions are customarily figured either as percentage of charge sales[85] for the year or as a percentage of accounts receivable.[86] Excessive additions may be subject to disallowance by the Commissioner.[87]

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[81] I.T. 3957, 1949 C.B. 65.

[82] I.T. 2365, VI-1 C.B. 69 (1927). Mim. 6209, 1947-2 C.B. 26.

[83] *Morris Plan Industrial Bank of N.Y.* (1944), par. 44,409 Prentice-Hall Memorandum T.C.; Mim. 3527, VI-1 C.B. 68; G.C.M. 938A, VI-2 C.B. 206.

[84] G.C.M. 938A, VI-2 C.B. 206.

[85] *Transatlantic Clock & Watch Co.*, 3 B.T.A. 1064 (acq.); *Henry, Inc.*, 13 B.T.A. 1234 (1928); *Medical Diagnostic Assn.*, 12 B.T.A. 610 (1928) (acq.); *Home Ice Cream Company*, 19 B.T.A. 762 (1930) (non-acq.); *Proctor Shop, Inc.*, 30 B.T.A. 721 (1934); *Apollo Steel Co.* (1945), par. 45,128 Prentice-Hall Memorandum T.C.; Mim. 3527, VI-1 C.B. 68.

[86] *Wood Furniture Co.*, 21 B.T.A. 564 (1930) (non-acq.); *Axelson*, Tax Court memorandum opinion, entered May 27, 1946 Docket Nos. 6140, 6141.

[87] *C.P. Ford & Co., Inc.*, 28 B.T.A. 156 (1933); *Fabick Tractor Co.* (1948), par. 48,002 Prentice-Hall Memorandum T.C.; G.C.M. 938A, VI-2 C.B. 206; *Maverick Clark Litho. Co. v. Com.* (CA-5), 180 Fed. (2nd) 587 (1950); *Halley Office School Supply & Printing Co.*, Tax Court memorandum opinion, entered June 27, 1950, Docket No. 20,371; *Holmes-Darst Coal Corp.*, Tax Court memorandum opinion, entered February 5, 1952, Dockets Nos. 15,529, 22,276; *Mendel Levitz et al.*, Tax Court memorandum opinion, entered August 29, 1952, Docket No. 33,741.

In general the use of the reserve method of providing for bad debt losses will tend to place larger deductions in years showing greater activity and presumably more profit and lesser deductions in recession years with smaller net income or even losses. As a result, an actual tax saving from the operation of the reserve over a period of years may be expected.

Without intending to go into the detailed provisions of Mimeograph 6209, the method prescribed by the Service for banks permits the establishment of a reserve and charges to income for additions to the reserve which effect the following:

(a) Maintenance of a reserve at a balance, the minimum of which equals a percentage of outstanding loans at the end of the year, based on actual bad debt experience of 20 years including the taxable year, and the maximum (ceiling) of which is equal to three times the minimum.

(b) Charges to income equal in amount to the minimum balance plus or minus an adjustment, if necessary, to bring the reserve either *up* to the minimum balance or *down* to the maximum (ceiling).

If at the end of any taxable year it is found that the balance in the reserve (before credit of the current year's provision) is greater than the computed ceiling, the reserve need not be reduced by a negative provision.[88] Reversal of a reserve, and additions to the reserve in subsequent years are matters of reasonableness and cannot be set aside by the Commissioner without good cause.[89]

11. How to Treat Recoveries of Bad Debts

The law excludes from gross income the recoveries of previously deducted bad debts to whatever extent the prior deduction did not result in an income tax benefit for the year of deduction. Such excluded part of a recovery is termed "recovery exclusion."[90] If the year of deduction was a loss year, a tax benefit may have resulted nevertheless by reason of a carry-over or carry-back of net operating loss.

For this purpose, the term "bad debts" includes worthless securities that are subject to the capital loss provisions.

The amount recovered may be cash or property, the latter at its fair market value. The amount recovered is to be applied (a) first to that part of the debt that had not been deducted if there be any such part (as would be the case in partial worthlessness), (b) then to the partial amount deducted as bad debt, to the extent of the "recovery exclusions" (beginning with the latest year going back). (c) Any remainder of the amount recovered is that part of the bad debt for which a tax benefit had been obtained, and (d), in exceptional cases, a gain (if the recovery is greater than the debt.)[91]

Parts (c) and (d) of the recovery amount represent income in the year of receipt.

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[88] Special ruling dated Decemer 29, 1947. I.T. 3936, 1949—1 C.B. 64, Special ruling dated June 14, 1948.

[89] *Empire Case Goods Co.* (1949), par. 49,186 Prentice-Hall Memorandum T.C.; *Porter & Co.*, 14 T.C. 307 (1950) (acq.). Affirmed on other grounds (CA-3), 187 Fed. (2nd) 939 (1951); *American Pitch Pine Export Co.*, Tax Court memorandum opinion, entered November 2, 1949, Docket 17,680 affirmed on other grounds (CA-5), 188 Fed. (2nd) 721 (1951).

[90] 1954 IRC Sec. 111; 1939 IRC Sec. 22(b)(12).

[91] Reg. 118, Sec. 39.22(b)12-1.

Recoveries on bad debts previously charged to the bad debt reserve are not income as such, but are to be credited to the reserve. This decreases the addition to the reserve for the current year that is necessary to bring it up to a reasonable amount.

12. How Other Sections of the Tax Law Affect Bad Debts

Bad debt deductions that are part of business losses may be carried back two taxable years and carried over five taxable years along with a net operating loss.

Bad debts that are deductible only as a capital loss are subject to the limitations applying to net capital losses. Corporations may deduct capital losses only to the extent of the capital gains for the same taxable year, and may consequently never deduct a net capital loss. Taxpayers other than corporations may deduct a net capital loss to the extent of net income (computed without regard to capital gains or losses) or $1,000, whichever is the smaller amount. The excess of the net capital loss over the amount deductible may be carried over for five consecutive taxable years and be applied similarly against capital gains or net income, or both.

Section 6511(d) of the Internal Revenue Code of 1954 (Sec. 322(b)5 of the 1939 Code) provides for a special period of limitation with respect to bad debts and worthless securities, in that a claim for credit or refund of income taxes, based on worthlessness of debts or securities, may be filed within a period of seven years, from the date prescribed by law for filing the return for the year in respect to which the claim is made.

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How to Get Deductions for Depletion

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1. Points to Consider

The preliminary points for consideration involve the answers to the following:

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What is depletion? 2
What types of property are subject to depletion? 3
To whom is the allowance for depletion permitted? 4
What is the purpose of the allowance? 5

The various methods of computing depletion are discussed following the answers to these questions.

The two methods available are:

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Cost depletion 6
Percentage depletion 7

Other factors that need to be considered in connection with depletion are:

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2. What Is Depletion?

Under the terms of the income tax law as set forth in the Internal Revenue Code, depletion is a deduction from gross income that represents loss of value of such assets as mines, oil and gas wells, other natural deposits, and timber brought about by a reduction in the quantity of these assets as a result of extraction operations.

For another definition of depletion, see *U.S.* v. *Ludey*.[1]

In the computation of the Federal income tax, a reasonable allowance is permitted for depletion under the law[2] and under the rules and regulations prescribed by the Secretary of the Treasury or by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury.[3] The allowance for depletion is an annual deduction.[4]

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[1] *U.S.* v. *Ludey*, 274 U.S. 295, 6 AFTR 6754.

[2] The law is set forth in the Internal Revenue Code. IRC §§ 611, 642(e), 612.

Depletion should be sharply distinguished from depreciation, which is an allowance for loss of value resulting from wear and tear, and from obsolescence of property used in a trade or business or in any other manner for the purpose of obtaining income.[5] Cost of improvements to depletable property should be segregated in the accounts, and depreciation on them claimed on a pro rata basis over the life of the improvements or of the depletable property, whichever is less.[6] This is always desirable, and in cases where "percentage depletion" [7] is claimed, the taxpayer obtains an advantage in making the separate claim for depreciation, because otherwise it would be lost in the depletion allowance which may not be increased for improvements.

3. What Types of Property Are Subject to Depletion?

Property subject to depletion includes (a) Mines, (b) Oil and gas wells, (c) Quarries, (d) Other natural deposits, and (e) Timber. Oyster beds, however, are not subject to depletion.[8]

The deduction for depletion is allowed to the owner of an economic interest in the five types of property listed above, in conformity with the methods and to the extent prescribed by the law[9] and the Regulations (when issued).[10]

An *economic interest* in these properties is a right acquired in conformity to law, to receive income from the use of the mineral or timber "in place," and from the sale of the mineral or timber content of the properties. The gross proceeds from the sale of their mineral or timber content includes a return of capital.

Where the economic interest is acquired by investment of a capital sum of money, the amount paid for the interest is known as the depletable capital sum. Two elements are, therefore, usually present:

1. A purchase price paid for an economic interest (the depletable capital sum).
2. Receipt of the proceeds or of a share in the proceeds from the sale of the mineral or timber content.

In the case of "Percentage Depletion," [11] however, it is not necessary, as a basis for the computation of the depletion allowance, to have a depletable capital sum based on cost or March 1, 1913 value.[12]

Expenditures in connection with an economic interest may represent capital additions which may not be deducted in the year in which they are made, but must be recovered through the depletion or depreciation deduction; they may represent business expenses which may be deducted in the year in which they occur; or they may represent items with respect to which the taxpayer may elect to handle as capital additions or as expense.

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[3] The Regulations are in process of preparation and approval.

[4] I.T. 2350, VI-1 C.B. 20.

[5] 1954 IRC §§ 167, 642(e); 167(f).

[6] See Section 10 of this chapter.

[7] See Section 7 of this chapter.

[8] I.T. 1835, II-2 C.B. 148.

[9] 1954 IRC §§ 611; 642(e); 167; 612; 691(2).

[10] The Regulations in reference to depletion have not yet been issued.

[11] See Section 7 of this chapter.

[12] *Louisiana Iron & Supply Co.*, 44 B.T.A. 1244 (1941); *Second Carey Trust*, 14 B.T.A. 120, affirmed on other issue (D.C. 1942) 126 F. (2d) 526, 28 AFTR 1371, 42-1 U.S.T.C. 9331, den. 317 U.S. 642; *Cowan Drilling Co.*, 130 Fed. (2d) 62.

Improvements to the property representing equipment used in operations, such as drilling tools, machinery, engines, boilers, tanks, casing, pipe and structures must be capitalized, and written off through the depreciation deduction.[13]

Certain items represent additions to the depletable capital sum subject to the depletion allowance, and not deductible as expense in the year in which they are acquired or the sums expended. Thus, commissions paid to acquire a five-year lease must be capitalized and written off through the depletion deduction, even though the lease was subject to forfeiture after one year under certain conditions.[14] This is also true with respect to exploration costs of a geological and geophysical nature; if the property is abandoned as a source of income, the amount thus capitalized is a deductible loss at the time of abandonment.[15] If a geological survey is undertaken with a view to determining whether extensive exploration is advisable, the costs must be capitalized.[16]

Expenditures for drilling may be treated as capital additions subject to the depletion allowance;[17] but if the taxpayer elects to regard them as expenses, they must be deducted on his tax return in the year in which they are paid or incurred, and may not be deferred pending completion of the well.[18]

In one case, the cost of a dry or non-productive well was written off as an expense during the taxable year in which the costs were incurred; this single well was the only one that was completed during the particular year. The taxpayer elected to treat the expenditures as expense, but it was held[19] that fact did not constitute an election either to capitalize or to charge to expense intangible drilling costs of subsequently completed wells that proved productive.

Where an agreement was made between two parties whereby the first party was to acquire a fractional interest in a lease and a well in process of being drilled, and the second party was to bear all the drilling costs; the amount paid by the first party was regarded as a capital investment, and not a drilling expense with election as to deduction or capitalization.[20]

Generally speaking, however, intangible drilling and development costs of operator may be either capitalized or charged to expense at the taxpayer's option.[21] The election, when made, is binding for all subsequent years.[22]

4. To Whom Is the Allowance Permitted?

Generally speaking, the allowance is permitted to the possessor of an economic interest in depletable properties (that is, in the mineral or timber in place) who receives the proceeds or a share in the proceeds from the sale of their content where these proceeds include a return of capital.

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[13] See footnotes 3 and 10.
[14] *L. S. Munger*, 14 T.C. 1236.
[15] I.T. 4006, C.B. 1950-1, 48.
[16] *Louisiana Land and Exploration Co.*, 7 T.C. 507. affirmed on other issues, 161 F. (2d) 852.
[17] *Fleming* v. *Commissioner* (C.C.A.-5), 41-2, U.S.T.C. 9590, 121 F. (2d) 7.
[18] *Great Western Petroleum Corp.*, 1 T.C. 624.
[19] *Hawkeye Petroleum Corp.* v. *Commissioner*, 18 T.C. 1223.
[20] *Platt* v. *Commissioner*, 18 T.C. 1229.
[21] See footnote 10.
[22] See footnote 10.

Where two or more economic interests exist with respect to any depletable property, the allowance for depletion is allocated to the owners of these economic interests as their interests may appear.

The following fall within the category of those possessing economic interests in depletable properties, and are, therefore, entitled to their properly allocated share of the depletion deduction:

1. Operating owners[23]
2. Purchasers of royalty interests[24]
3. Owners of fractional or over-riding royalty interests[25]
4. Lessors or assignors, where an economic interest is retained such as a right to share in the net profits[26]
5. Lessees or assignees,[27] including assignee of "in-oil payments" rights[28]
6. Sublessors[29]
7. Sublessees[30]
8. Life tenants, but not remaindermen[31]
9. Trusts[32]
10. Beneficiaries of trusts[33]
11. Coal stripping contractor[34]

A strip miner who files his tax returns on an accrual basis and provides a reserve for the costs of back-filling is permitted to deduct the amount added to the reserve.[35]

Where depletable properties are leased and an economic interest is retained by the lessor, that retained economic interest also has a cost that is available as a base for cost depletion. The retained economic interest stems from the earlier acquired economic interest where the acquisition was by bona fide purchase, and the cost of the interest is the purchase price. Where the lessor's interest is a "right to share in the oil produced," it is subject to depletion.[36]

Among those who are not permitted to take any deduction for depletion are the following:

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[23] 1954 IRC §§ 162; 611; 642(c).

[24] I.T. 1894, III-1 C.B. 186.

[25] I.T. 2278, V-1 C.B. 65.

[26] *T. W. Lee*, 42 B.T.A. 1217 (1940), affirmed (5 Cir. 1942) 126 F. (2d) 825, 28 AFTR 1520; *E. C. Laster*, 43 B.T.A. 159 (1941) affirmed (5 Cir. 1942) 128 F. (2d) 29 AFTR 465; *Kirby Petroleum Co., et al.* v. *Commissioner*, 326 U.S. 599, 34 AFTR 526; *E. G. Palmer* v. *Bender* (Sup. Ct.), 3 U.S.T.C. 1026, 287 U.S. 551.

[27] *Spalding* v. *U.S.* (9 Cir. 1938), 97 F. (2d) 697, 21 AFTR 564, cert. den. 307 U.S. 644.

[28] I.T. 4003, 1950-1 C.B. 10.

[29] *Lynch* v. *Alworth-Stephens Co.*, 267 U.S. 364, 5 AFTR 5258.

[30] I.T. 2722, XII-2 C.B. 198.

[31] 1954 IRC § 611; 642(e).

[32] Footnote (31) above.

[33] Footnote (31) above.

[34] G.C.M. 26,290, 1950-1 C.B. 42.

[35] *Paul Harrold* v. *Commissioner* (CA-4), 192 Fed. (2d) 1002.

[36] *Palmer* v. *Bender*, 287 U.S. 551, 11 AFTR 1106.

1. Buyer of capital stock of an oil company out of profits accruing to him[37]
2. Owners or operators of coal culm banks (coal refuse piles) because such coal does not constitute a mine or a natural mineral deposit[38]
3. Assignor who makes an absolute assignment equivalent to a sale[39]

Where depletable property is sold outright, the economic interest in the property ceases and with it the right to claim depletion.

Some question arises, however, when the vendor retains a right to a share in the net profits. It has been held that retention of a right to share in the net profits gives its possessor an economic interest;[40] and that it is not necessary for him to possess any royalty rights in addition to his share in the net profits.[41] But in an earlier case,[42] a taxpayer was held to have sold his entire economic interest even though the sales price included a share in subsequent profits.

Top soil. Soil "in place," and therefore top soil, is a natural deposit, just as gravel is. Thus, the sale of top soil results in ordinary income and not in a capital gain. Under a recent ruling,[43] it was held that the proceeds from the sale of top soil subject to the depletion allowance constituted ordinary income. The frequency of such sales, and the question of whether the top soil is primarily for sale to customers, apparently do not enter into the ruling. The burden of proof is on the seller of the top soil if he elects to treat the sale as resulting in a capital gain. If the matter were presented to a court, the decision might go either way, i.e., either as ordinary income or as a capital gain (or loss).

The question is not raised when the purchaser of the top soil comes on the property and removes the soil in bulk directly from its "place." [44] In this case the sale might be considered similar to a sale of mineral rights.

But whether the proceeds are to be regarded as resulting in ordinary gain or in a capital gain (or loss), the problem is in determining the "basis"—in the first instance for the computation of the depletion allowance; in the second for the computation of the capital gain or loss.

An occasional sale of top soil by the owner of the property is not in the regular course of business and yet apparently results in ordinary income. The right to claim the depletion deduction is clear.

5. Purpose of the Depletion Allowance

The gross return from the sale of the mineral or timber content of depletable properties represents, in part, a return to the taxpayer of a portion of his investment in the properties from which the product was removed. The income tax is, as its name implies, a tax on income. It is not the intent of the law to make a capital levy, as would be the case if no allowance for depletion were permitted. The primary purpose of the depletion allowance, therefore, is to prevent the levying of a tax on return of capital.

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[37] *Helvering* v. *T. A. O'Donnell* (Sup. Ct.), 38-1 U.S.T.C. 9156, 303 U.S. 370.

[38] *Kohinoor Coal Co.* v. *Commissioner* (CA-3) 49-1 U.S.T.C. 9114, 171 Fed. (2d) 880, cert. den. 337 U.S. 924.

[39] *Helvering* v. *Elbe Oil Dev. Co.* (Sup. Ct.), 303 U.S. 372; similarly in the case of deferred payments if such payments are not exclusively out of operations—*J. S. Anderson* v. *Helvering* (Sup. Ct.) 46-1 U.S.T.C. 9479, 326 U.S. 404.

[40] *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, 34 AFTR 526.

[41] *Burton-Sutton Oil Co.* v. *Commissioner*, 326 U.S. 755, 34 AFTR 1017, on remand 7 T.C. 1156 (1946); affirmed (5 Cir. 1947) 161 F. (2d) 588, 35 AFTR 1250; see also *Hiram T. Horton*, 7 T.C. 957.

[42] *Helvering* v. *Elbe Oil Land Development Co.*, 303 U.S. 372, 20 AFTR 787.

[43] Rev. Rul. 78, I.R.B. 1953-10, 2.

[44] *Battjes* v. *U.S.* (CA-6) 49-1, U.S.T.C. 9149, 172 F. (2d) 1.

To effect this purpose, the depletion allowance permits the owner of an economic interest the cost or other basis of his investment as the properties become exhausted. The deduction is taken pro rata as the reduction in the quantity of the reserves from the product occurs.

The deduction is based on an estimate of the quantity in place; if, therefore, during the course of operations, it becomes evident that the quantities are greater or less than that estimated, a revision is made, and the deductions for subsequent years are based upon the revised estimate.[45]

There are two methods of computing depletion permitted by the Internal Revenue Code and the Regulations. They are (a) cost depletion and (b) percentage depletion.

6. Cost Depletion

The two factors involved in the computation of cost depletion are (1) the number of units sold during the taxable year, and (2) the depletion allowance per unit. The depletion allowance for the taxable year is computed by multiplying the first of these factors by the second.

Number of units sold during the taxable year. The number of units sold during the year is self-explanatory, except for the difference in handling, as between cash basis and accrual basis taxpayers.

Depletion allowance per unit. In the selection of the unit for the purpose of the computation of cost depletion, the customary units in the trade or industry should be used.[46] These are the units ordinarily used in the sale and payment for the product, for example: (1) *tons* of ore; (2) *barrels* of oil; (3) *thousands of cubic feet* of natural gas.

The two factors involved in the computation of the depletion allowance per unit are: (1) the adjusted basis; and (2) the number of units remaining "as of the taxable year." These two factors are explained in the paragraphs following.

The depletion allowance per unit is computed by dividing the adjusted basis (the first of the two factors) by the number of units remaining "as of the taxable year" (the second factor).

The adjusted basis in cost depletion. A distinction must be made between "basis" and "adjusted basis." The basis for the computation of cost depletion is the same as the basis for the computation of gain on the sale or other disposition of the property.[47] This basis is the portion of the cost of the investment in the depletable property which is allocable to what may be extracted.[48] Or some other statutory basis, as, for example, the fair market value (see "Fair Market Value" in this article, below) may be used.[49]

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[45] See footnote 10.
[46] See footnote 10.
[47] 1954 IRC § 612.
[48] 1954 IRC § 1012.

The cost, or other statutory basis, must be adjusted in conformity with law.[50] In the case of depletable property, this adjustment includes depletion claimed in prior years. The adjusted basis consists of *cost, fair market value,* or other statutory basis (unadjusted), adjusted for the addition of *"Plus Adjustments"* and the subtraction of *"Minus Adjustments."*

Cost. Cost means the purchase price of the economic interest. This purchase price must have been paid as the result of a bona fide purchase, and is represented by the amount of cash invested in the property.[51] The amount of cash invested in the property may be cash paid outright, or it may be the promise of the payment of cash (such as a mortgage bond). If the property is acquired in any other way, such as, for example, the issue of shares of capital stock, or by gift, etc., other methods of determining the unadjusted basis are used.[52] If the property is acquired by a corporation in exchange for the issue of shares of its capital stock, the value of these shares becomes the cost of the property; the value of the shares is determined by the price of similar shares sold at the time of the acquisition. If the shares are listed on a securities exchange, the price at which shares exchanged hands is reported in the financial pages of the daily newspapers.

Cost does not mean the entire cost of the property, but only that portion of the cost allocable to the units that may be extracted.[53] Hence, the following cannot be included in the cost basis of the depletable property:

1. Land not used in production, or not containing mineral, or that part of the basis of the land representing a value other than mineral content.
2. Improvements or other items, the cost of which may be recovered through depreciation or through deductions other than depletion.
3. Residual value of the property.

By excluding these and similar items, only that portion of the cost which represents the purchase price of the extractable units is allocated to the basis for depletion.

The taxpayer may elect to treat the "intangible drilling and developments costs" of oil and gas wells as cost of the depletable property. Such costs would normally include items of fuel, hauling, repairs, supplies, labor, and similar items incurred in connection with the drilling of gas and oil wells and the preparation of them for production.[54] For the purpose of making the election, according to the regulations,[55] these items are not considered to have salvage value "even though used in connection with the installation of physical property which has a salvage value."

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[49] 1954 IRC §§ 307; 334(c); 358; 362; 334; 373; 372; 1013; 1014; 1015; 1031; 1032; 1033; 1091; 1051; 1052; 723; 732; 1053.

[50] 1954 IRC § 1011.

[51] See footnote 10.

[52] 1954 IRC § 1015; 1014 and others. See also section on "Fair Market Value" in this article.

[53] Reg. 118, § 39.23(m)-2.

[54] Reg. 118, § 39.23(m)-16.

[55] Reg. 118, § 39.23(m)-16(b)(1)(i)(C).

The taxpayer should realize, however, that if he adds such costs to his capital account, he cannot deduct them for income tax purposes. Instead, he will recover them through the annual depletion deduction if he uses cost depletion. It is particularly desirable to add such items to the cost of the depletable property if the taxpayer uses percentage depletion,[56] because his net income is reported at a larger amount by omitting the items from the business and operating expenses.

Fair market value. In certain cases, such as gifts, transfers in trust, and property transmitted at death,[57] the fair market value[58] may be used as a basis for the computation of the depletion allowance.

Fair market value is defined [59] as "that amount which would induce a willing seller to sell and a willing buyer to purchase." This value may be determined by assuming such a transaction to have taken place, but only in the light of all the circumstances and conditions known at that time and regardless of later knowledge or developments. This valuation is subject to approval or revision by the Commissioner.[60]

Once this valuation has been approved or settled after revision by the Commissioner, it cannot be changed, except in the case of the subsequent discovery of certain non-metallic minerals.[61] Change may also be permitted where misrepresentation or fraud was involved in the original valuation, or where there was gross error in the facts known on the valuation date. But the change must have the written approval of the Commissioner.[62]

"If the fair market value must be ascertained as of a certain date, analytic appraisal methods will not be used if the fair market value can reasonably be determined by any other method." [63]

One of these methods of valuation by analytic appraisal is explained in the Regulations:[64] namely, the present value method.

"Plus" and "minus" adjustments. These adjustments are 1. "*Plus adjustments:* expenditures, receipts, losses or other items properly chargeable to capital account.[65] The capital expenditures include only those items which are properly allocable to the units that may be extracted. Hence capital expenditures made for property that is subject to depreciation, and items that may be deducted in any other way than by the depletion allowance in the computation of the net taxable income, cannot be included.

2. "*Minus*" *adjustments:* depletion allowed, but not less than the depletion allowable.[66]

Units remaining "as of the taxable year." The second of the two factors mentioned above as being involved in the computation of the depletion allowance per unit is the number of units remaining "as of the taxable year."

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[56] See section 7 of this chapter, "Percentage Depletion."

[57] 1954 IRC §§ 1015; 1014; and others.

[58] See footnote 10.

[59] See footnote 10.

[60] *Ibid.*

[61] *Ibid.*

[62] *Ibid.*

[63] *Ibid.*

[64] *Ibid.*

[65] 1954 IRC § 1016.

[66] 1954 IRC § 1016.

The number of units of mineral remaining as of the taxable year is explained[67] as being the sum of the following:

1. Units remaining at the end of the taxable year. This includes not only the units still "in place," but also those that have been recovered, but have not been sold.
2. Units sold during the year.

The mineral content should be determined by competent geologists or engineers. This determination should be made in conformity with the Regulations[68] and should therefore include, both as to quality and grade:

(a) Ores and minerals "in sight," "blocked out," "developed," or "assured," these words being used in their conventional meaning

(b) "Probable" or "prospective" ores and minerals (in the corresponding sense)

Unlike the cost or other statutory basis, which when once approved cannot be changed (without change of ownership) except for fraud, misrepresentation and gross error,[69] the estimate of the number of units of mineral content may be changed at any time when such a change can be justified.[70]

The estimate of units remaining "as of the taxable year" may be revised at any time, provided there is justification for the revision. This means that it is not obligatory to use the number of units remaining at the close of the previous year for the purpose of computing the number of units remaining at the close of the current year.

The revision may be made at any time, but there must be justification for it, resulting from operations or from development.[71] As to timber, new growth, losses and abandonment may also be taken into account.[72]

Although the estimate of units remaining may be revised from year to year, the adjusted basis may not be revised. In other words, the taxpayer may revise his estimate of the number of recoverable units at any time, but he is not permitted to revise the dollar amount of his investment recoverable through depletion.[73]

A revision of the estimate of the remaining units of mineral content becomes necessary and is justified whenever it is ascertained, either by the taxpayer or the Commissioner, that the remaining recoverable mineral units as of the taxable year are materially greater or less than the number remaining from the previous estimate.[74]

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[67] See footnote 10.

[68] *Ibid.*

[69] *Ibid.*

[70] 1954 IRC §§ 611, 642(e).

[71] 1954 IRC §§ 611; 642(e).

[72] See footnote 10.

[73] *McCahill* v. *U.S.*, D. Ct. Minn. 1941, 29 AFTR 1442; *American Sulphur Royalty Co. of Texas*, 34 B.T.A. 439 (1936); see also *McCahill* v. *Helvering* (8 Cir. 1935), 75 F. 2d 725, 15 AFTR 304.

[74] See footnote 10.

The revised estimate should be used for the purpose of computing the depletion deduction for the taxable year in which the revision is made.[75] It remains in effect until a new revision becomes necessary.[76] The revised estimate is not retroactive and cannot be applied to prior years.[77]

Original estimate unchanged. Where no change is made in the estimate of units of mineral content, the number of units remaining "as of the taxable year" (that is, the sum of the units remaining at the end of the taxable year plus the sum of the units sold during the year) is identical with the number of units remaining at the beginning of the taxable year.

The number of units in the original estimate is the "number of units remaining as of the taxable year" for the first taxable year. From this would be subtracted the units sold during the first year to arrive at the "number of units remaining as of the taxable year" for the tax return for the second taxable year; and similarly for succeeding years.

Revision of original estimate. When in conformity with the regulations,[78] a revision of the estimate is made, the starting point in the computation of the "number of units remaining as of the taxable year" is the number of units remaining at the end of the taxable year. To this is added the number of units sold during the year to arrive at the adjusted quantity at the beginning of the year.

Units sold during the year. The number of units sold during the year as used in the tax return should be supported by sales records kept in the quantities sold as well as in dollars (or other currency).

Taxpayers reporting on a cash basis will substitute for the number of units sold the cash receipts resulting from the sales. Thus a cash basis taxpayer will include receipts for the taxable year, even though the units were produced and sold in the prior year. He will exclude sales made in the current year where the cash has not been received until the subsequent year.[79]

For the accrual-basis taxpayer, the date of the sale is the effective date for reporting the income, regardless of whether collection was made in the current year or in the subsequent year.[80]

The "decline in closed or rock pressure" method[81] is permitted for the computation of units sold during the year in the case of natural gas wells where the annual production is not metered and cannot be estimated with reasonable accuracy. To use this method, accurate records of periodical pressure must be kept.

In the case of timber, the depletion takes place not at the time of sale, but at the time the timber is felled. Because of the difficulty of determining with any degree of accuracy the quantity of timber felled immediately after felling, the depletion is considered to have taken place as soon as the quantity felled is first definitely determined.[82]

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[75] *Ibid.*

[76] *Ibid.*

[77] *Petit Anse Co.* v. *Commissioner* (5 Cir. 1946), 155 F. (2d) 797, 34 AFTR 1415, cert. den. 329 U.S. 732.

[78] 1954 IRC §§ 611, 642(e).

[79] See footnote 10.

[80] *Ibid.*

[81] *Ibid.*

[82] *Ibid.*

The Regulations contain a description of timber accounts.[83]

Summary. By way of summary, the steps in the computation of cost depletion are as follows:

Step 1. Determine the adjusted basis.

Step 2. Divide the adjusted basis by the units remaining "as of the taxable year." (Note: the result of this division is the depletion allowance per unit.)

Step 3. Multiply the depletion allowance per unit by (a) the number of units sold (accrual basis taxpayer) (b) the number of units for which cash was received (cash basis taxpayer) (c) the number of units felled (timber).

7. Percentage Depletion

Percentage depletion may be used by taxpayers owning an economic interest in specific types of mineral properties named in the Internal Revenue Code.[84] No other taxpayer may use it. Hence while any mineral property may use cost depletion, only the ones specifically named may use percentage depletion.

The minerals to which percentage depletion is applicable and the rates per cent specified in the Code[85] for the computation of the percentage of the gross income from the property allowable for depletion, are as follows:

From the 1954 Code[86]

A. 27½ *per cent:* oil and gas wells

B. 23 *per cent:* (a) sulfur and uranium; (b) and if from deposits in the United States—anorthosite (to the extent that alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, beryl, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, quartz, crystals (radio grade), rutile, block steatite talc, and zircon, and ores of the following metals: antimony, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese mercury, nickel, platinum and platinum group metals, tantalum, thorium, tin, titanium, tungsten, vanadium, and zinc

C. 15 *per cent:* ball clay, bentonite, china clay, sagger clay, metals mines (if paragraph (B) (b) does not apply), rock asphalt, and vermiculite

D. 10 *per cent:* asbestos (if paragraph (B) (b) does not apply), brucite, coal, lignite, perlite, sodium chloride, and wollastonite

E. 5 *per cent:* (a) brick and tile clay, gravel, mullusksheells (including clam and oyster shells), peat, pumice, sand, scoria, shale, and stone, except stone described in paragraph (F) and (b) if from brine wells—bromine, calcium chloride, and magnesium chloride

F. 15 *per cent:* all other materials (including, but not limited to, aplite, barite, borax, calcium carbonites, refractory and fire clay, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magnesite, magnesium, carbonates, marble, phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for the use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (B)(b) does not apply) bauxite, beryl, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc, (including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (C), that the percentage shall be 5 per cent for any such other mineral when used or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include—

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[83] *Ibid.*

[84] 1954 IRC, § 613(b)(1)-(s).

[85] Footnote (84) above.

[86] Footnote (84) above.

(a) soil, sod, dirt, turf, water, or mosses, or
(b) minerals from sea water, the air, or similar inexhaustible sources.

The basic factor in the computation of percentage depletion is the gross income from the property.[87]

The subsidiary factor which limits the amount of percentage depletion that may be claimed is the net income from the property.[88]

The third factor is the cost depletion which may be claimed if it is greater than the percentage depletion computed by applying the specific rate to the gross income or greater than 50 per cent of the net income. Cost depletion has already been discussed.

In the case of those specific mineral properties which were referred to above, the Code permits the taxpayer to claim as a deduction for depletion the larger of the following:

1. A percentage of the gross income from the property, the rate being specified in the Code,[89] or 50 per cent of the net income from the property before deducting the depletion allowance, whichever is the lesser.
2. Cost depletion

The steps in the computation are therefore:

Step 1. Apply the rate to the gross income.
Step 2. Match it against the 50 per cent of the net income.

The lesser of the two is the percentage depletion.

Step 3. Compute the cost depletion. If this is greater than the percentage depletion as determined by comparing step 1 and step 2, use the cost depletion.

Gross income for percentage depletion. In a broad, general sense, the gross income is the selling price of the crude mineral product before the subjection of the product to any manufacturing, conversion, or refining processes.[90]

The larger the gross income, the larger the amount of percentage depletion that may be claimed. Hence, nothing should be excluded from gross income that may be properly included as provided by the law and Regulations.

In the case of oil and gas wells, the gross income from the property means the amount for which the oil and gas are sold in the vicinity of the well, before any manufacturing, conversion, refining, or transportation. Where the oil and gas are sold in this way, the gross income is the full selling price.[91]

In the case of other crude mineral products, the gross income is the income from "mining." [92] This means the amount for which the mineral is sold in the vicinity of the "mine" [93] before any manufacturing, conversion, or refining. "Ordinary treatment processes" [94] are not regarded as manufacturing conversion, or refining, and may, therefore, be included in the gross income. Where the crude mineral product is sold before any of these processes have taken place, the full selling price, including compensation for "ordinary treatment processes" is to be taken as the gross income.

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[87] *Ibid.*
[88] *Ibid.*
[89] 1954 IRC, § 613(b)(1)-(s).
[90] 1954 IRC, § 613(b)(4).
[91] See footnote 10.
[92] 1954 IRC, § 613(c)(2) for definition of "Mining."
[93] See footnote 10.
[94] *Ibid.*

For taxable years beginning after 1949, the cost of transporting ores or minerals from the mine to the place where the ordinary treatment processes are applied is added to the gross income. If the transportation is for 50 miles or less, the cost is automatically added to the gross income. If the distance is more than 50 miles, the cost is added to gross income if the Secretary of the Treasury finds the physical and other requirements are such that the ores or minerals must be transported more than 50 miles.[95]

Ordinary treatment processes include all those processes that are necessary to make a commercially salable product out of the crude mineral. To illustrate: before coal at the mine can be sold, it is necessary to clean it, to break it, to sort it according to size, and to load it for shipment. These are ordinary treatment processes and should be included in gross income.[96]

The ordinary treatment processes listed[97] are summarized below:

1. *Coal:* Cleaning, breaking, sizing, and loading for shipping
2. *Sulphur:* Pumping to vats, cooling, breaking, and loading for shipping
3. *Minerals which are customarily sold in the form of crude mineral product:* Sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipping
4. *Minerals which are not customarily sold in the form of a crude mineral product:* Crushing, grinding, and beneficiation by processes to separate the product from the ores.
5. *Quicksilver ores:* Furnacing is included.

If, however, the ordinary treatment processes are not applied at the mine, then it becomes necessary to exclude from gross income that portion of the selling price that is allocable to the transportation costs from the mine to the processing location.[98]

The following are listed[99] as being processes not to be included as "ordinary treatment processes":

1. Electrolytic deposition
2. Roasting
3. Thermal or electric smelting
4. Refining
5. Substantially equivalent processes

Wherever, therefore, the taxpayer adds to the selling price any amounts that represent compensation for manufacturing, conversion, refining, or transportation, it is necessary to divide the selling price into two parts, as follows:

1. The part of the selling price allocable to the crude mineral product.

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[95] 1954 IRC, § 613(c)(2).
[96] See footnote 10.
[97] *Ibid.*
[98] *Ibid.*
[99] *Ibid.*

2. The part of the selling price allocable to manufacturing, conversion, refining and transportation.

Where the owner or operator engages in manufacturing, conversion or refining, and sells the finished product rather than the crude mineral, the selling price includes compensation to the owner or operator for these processes. In the computation of the gross income for depletion purposes, the amount included in the selling price that represents compensation to the owner or operator for manufacturing, conversion, or refining must be excluded. Only that portion of the selling price that represents compensation to the owner or operator for the crude mineral may be included.

"Ordinary treatment processes" should be sharply distinguished from manufacturing, conversion, and refining processes. The ordinary treatment processes should not be removed from the selling price in order to determine the gross income for percentage depletion.[100]

Rents, royalties, and oil payments paid or incurred by the taxpayer are excluded from the gross income from the property for the purpose of the percentage depletion computation. This is also true of any bonus paid during the taxable year that is applicable to the product sold during the year. It is also true of any advance royalties if they are properly deductible from income for the purpose of the computation of the income tax.[101]

Rents, royalties, and oil payments made to the lessor or assignor who has retained an economic interest in the mineral in place are considered as going directly to the lessor or assignor from the property. The lessor or assignor is entitled to a deduction for depletion from this income. This money is, therefore, no part of the income of the producer. The fact that the money passed through his hands is purely incidental, and does not make the money income. Hence, such payments must be excluded from the gross income of the producer.[102]

Bona fide cash discounts should be included in the gross income from the property for percentage depletion.[103] Bona fide cash discounts are discounts allowed for payment within a short period of time (say 10 days) and are granted to customers for the purpose of speeding up collections.

They should be sharply distinguished from trade discounts, which are allowed regardless of time of payment. Trade discounts cannot be included in gross income.[104]

Trade discounts are deductions from catalogue or list prices. They are designed solely for the purpose of adjusting the catalogue or list price to the market price. The catalogue or list price may be purely arbitrary; it is the market price that has significance. It is the market price that is the real selling price, and it is this amount that is included in gross income. If trade discounts appear in the accounts (which is contrary to normal practice), they must be excluded from the gross income.[105]

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[100] See footnote 10.

[101] *Ibid.*

[102] *Thomas* v. *Perkins,* 301 U.S. 655, 19 AFTR 538; *Caldwell Oil Corp.,* 47 B.T.A. 707 (1942), affirmed (1944) 141 F. (2d) 599, 32 AFTR 434; also see *Anderson* v. *Helvering,* 310 U.S. 404, 24 AFTR 967.

[103] *Montreal Mining Co.,* 2 T.C. 688 (1943) reversed per stipulation on other issue (6 Cir. 1944), 33 AFTR 1660.

[104] Footnote (103) above.

In the computation of gross income for percentage depletion, proceeds from the sale of equipment that has been discarded must be excluded.[106]

Whatever is excluded from gross income reduces proportionally the amount of the percentage depletion that may be claimed. Generally speaking, the items that must be excluded are the following:

1. Compensation for manufacturing, conversion and refining paid to the taxpayer as part of the selling price of the product.
2. Compensation for transportation paid to the taxpayer as part of the selling price of the product. This second item includes also any amount added to the selling price to cover transportation between the mine and the location where the "ordinary treatment processes" are applied.

Net income from the property before depletion. The second factor to be considered in the computation of percentage depletion is the net income from the property before depletion.[107] Importance attaches to this factor because percentage depletion cannot exceed 50 per cent of the net income before depletion. If the depletion based on percentage of gross income exceeds 50 per cent of the net income before depletion, the depletion deduction must be reduced to the 50 per cent of the net income before depletion, or the cost method of computing depletion must be adopted.

The net income from the property before depletion is the difference between the gross income and the allowable deductions provided for in the Code for overhead, operating expenses, depreciation, taxes, losses sustained, and the like.[108]

To be deductible, the items must be properly allocable to the mineral property. A mineral property is defined[109] as "the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land necessary for purposes of mineral extraction."

Among the items that must be deducted in arriving at the net income from the property before depletion are the following:

1. Development expenses deducted in computing taxable net income.[110]
2. Exploitation costs where deducted in computing taxable net income.[111]
3. Loss deductions resulting from exploitation costs that have been capitalized, if the loss deduction has been taken in the computation of the taxable net income.[112]
4. Interest on money borrowed for development purposes.[113]
5. Silicosis claims.[114]

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[105] Footnote (103) above.
[106] *Monroe Coal Mining Co.*, 7 T.C. 1334.
[107] See footnote 10.
[108] 1954 IRC §§ 161; 212; 162; 163; 164; 165; 166; 167; 168; etc.
[109] See footnote 10.
[110] *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90.
[111] G.C.M. 22,689, 1941-1 C.B. 225.
[112] Footnote (111) above.
[113] *Mirabel Quicksilver Co.*, 41 B.T.A. 401 (1940).
[114] *Montreal Mining Co.*, 41 B.T.A. 399 (1940).

6. State income taxes.[115]

Intangible drilling and development costs[116] also affect the computation of percentage depletion. The taxpayer may elect to treat them either as current expenses or as capital expenditures. In the first instance, the taxpayer will deduct the costs from his gross income, both for the purpose of computing his taxable net income, and for the purpose of determining the net income for percentage depletion. His income tax will be less, but his maximum percentage depletion will also be less. This is because the 50 per cent of the net income from the property before depletion will be less. His basis for cost depletion will be less if he elects to use cost depletion.

In the second instance, the taxpayer will add the costs to his property account, and recover the cost through the annual depletion deduction (if he uses cost depletion). His income tax will be somewhat higher, but his maximum percentage depletion will also be higher, because his net income is higher.

The taxpayer must make a binding election as to whether he will treat these costs as expenses or as additions to property account.[117]

This election must be made with respect to intangible drilling and development costs incurred by an operator in a taxable year beginning after December 31, 1942.

The Regulations previously in effect state[118] further: "The absence of a clear indication in such return of an election to deduct as expenses intangible drilling and development costs shall be deemed to be an election to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property."

This election, once made, is binding for all subsequent years.

Charitable contributions are not deductible in determining the net income from the property before depletion for the purpose of the computation of the percentage depletion deduction. They are not a necessary part of the operating costs properly allocable to the extraction operations.[119]

Gross or net income from what property? The gross and net income must be computed for each separate mineral property and for each depletable economic interest owned by the taxpayer.

Separate computations must be made by the taxpayer for each mineral property or economic interest in mineral property in order to determine the separate gross and net income for purposes of the percentage depletion computation.

The separateness of the property may be determined by examination of the time and manner of its purchase, the fact of there being different geographic tracts, or the fact of there being different interests in the same geographic tract.[120] The Tax Court apparently has not accepted these memoranda, however, and has held that if a property is a single operating unit, it is a single property, even though it may have been acquired piecemeal at different times.[121]

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[115] *Grison Oil Corp.*, 42 B.T.A. 1117 (1940).

[116] See footnote 10.

[117] *Ibid.*

[118] Footnote (117) above.

[119] *F.H.E. Oil Co.*, 3 T.C. 13 (1944), affirmed on other issue (5 Cir. 1945), 147 F. (2d) 1002, 33 AFTR 785.

[120] G.C.M. 22,106, 1941-1 C.B. 1245; G.C.M. 22,956, 1941-2 C.B. 103; G.C.M. 24,094, 1944 C.B. 250.

Contiguous parcels may be considered as a single mineral property, even though acquired at different times, provided the taxpayer regards them as a single property and has been consistent in his computation of the depletion deduction as though they were a single property.[122]

Noncontiguous parcels, however, are not a single property, even though they were acquired at the same time and by the same instrument.[123]

Election to use percentage depletion. The taxpayer is not required to make a binding election to use percentage depletion. He is not bound by any prior election. He may use cost depletion in one year, for example, and percentage depletion the following year, and then return to cost depletion if he wishes. Even after the return has been filed, the method used in that return is not binding provided a recomputation of the tax is made.

For years, prior to January 1, 1942, the taxpayer was required to make a binding election, but this was repealed by the Revenue Act of 1942.[124]

Because of the ease with which it can be computed, as compared to cost depletion, taxpayers might use percentage depletion and suffer a loss because it does not give them the maximum tax benefit.

The taxpayer should be careful, in every case, to compute both the percentage depletion and the cost depletion, and then select the method that provides the maximum deduction, and consequently the lesser tax.

Cost depletion may be used even when it exceeds 50 per cent of the net income before depletion, and even where it is in excess of the amount of percentage depletion based on gross income.

8. How to Find Which Method to Use

Under the 1954 Code, the discovery basis or method can no longer be used. However, all the minerals that fell into this classification are now included under the percentage method.

Taxpayers who are permitted to use percentage depletion have the choice between that method and cost depletion. In order to obtain the maximum tax benefit, they should select:

1. The specified rate of the gross income, if that is less than 50 per cent of the net income and greater than the cost depletion.
2. 50 per cent of the net income, if that is less than the specified rate of the gross income and greater than the cost depletion.

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[121] *Black Mountain Corp.*, 5 T.C. 1117 (1945); see *Rialto Mining Corp.* (1946), par. 46,148 Prentice-Hall Memorandum T.C.; *Clover Splint Coal Co.* (1946), par. 46,252 Prentice-Hall T.C.; see *Gifford-Hill & Co.*, 11 T.C. 802, affirmed 180 F. (2d) 655; *Morrisdale Coal Mining Co.*, 13 T.C. 448.

[122] *Amherst Coal Co.*, 11 T.C. 209.

[123] *Berkshire Oil Co.*, 9 T.C. 903 (1947).

[124] Revenue Act of 1942, 145(a); for effective date, Revenue Act of 1942, 101.

3. The cost depletion, if that is greater than the maximum allowable percentage depletion.

Timber properties are not permitted to use percentage depletion.

9. Depreciation Where Depletion Is Also Involved

The depletion deduction is an allowance for the exhaustion of the mineral or timber content of the property. The depreciation deduction is an allowance for the wear and tear of improvements and equipment.

Separate records for depreciable and depletable property should be maintained, because the depreciation deduction may otherwise be lost if percentage depletion is claimed.

The depreciation deduction should be taken either over the life of the depreciable property, or on the basis of the exhaustion of the mineral or timber content of the property, whichever is shorter, or provides the larger deduction. If, however, the equipment, tools, and the like may be used at another location, the depletion of the mineral or timber property is not a factor.[125]

10. Accounting Records and Statements

Accounting records. Taxpayers are required to keep the necessary accounting records to support the various items in the tax return.

As far as depletion accounting is concerned, the following records[126] should be kept:

1. Cost of each mineral property
2. Costs of improvements
3. Dispositions of property
4. Depletion allowed or allowable for each taxable year
5. Production and sales records in quantities
6. Depreciation records
7. Accounts that will result in a fair presentation of the gross income and the net income, together with proper reconcilements of these amounts with the gross income for depletion and the net income for depletion (for percentage depletion)

Statements to be attached to the return. The following statements are to be attached to the return:

1. Complete description of the property, showing location, valuation and basis and method of valuation
2. Estimated number of units remaining at the end of the taxable year
3. Number of units sold and number of units paid for during the taxable year
4. Gross amount received for the sale of the mineral
5. Computation of depletion based on cost, even though percentage depletion is claimed

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[125] Christian Oehler, *Audits and Examinations*, page 353. New York: The American Book Company, 1949.

[126] See footnote 10.

6. Complete description of any economic interest other than ownership of the properties themselves
7. Acreage of oil and gas land, number of wells, new wells and date of completion, abandoned wells and date of abandonment, property map, geological information, and similar information

The above list is not complete; it serves to give a general idea of what is required.

Where percentage depletion is claimed, a statement must be attached to the return so that the gross income and the net income for percentage depletion may be readily ascertained and reconciled with the taxable net income shown on the return.

Where the taxpayer claims depletion for timber, Form T-Timber must be filled in and attached to the return.

In addition the taxpayer should attach to the first tax return filed after the property is acquired certified copies of the instrument or instruments whereby the property was acquired. Certified copies of these instruments need not be filed with subsequent returns.

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32

How to Get Deductions for Research and Promotion Costs

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The ratio of cases won to those lost in this area of taxation is not particularly encouraging from the taxpayer's standpoint. An underlying principle that costs of earning current income are currently deductible, whereas an investment in future profits must be capitalized,[1] has long been recognized by Congress and the courts. In marginal cases, the taxpayer has found that practical business considerations constitute a poor sword against the Commissioner's upraised shield of the burden of proof.[2] However, in the Revenue Act of 1950, Congress decided to bend long-standing principle in the case of circulation costs. This policy was extended in large measure to research and experimental costs in the Internal Revenue Code of 1954, with a view to meeting business needs for incentive and practicality.

While there are certain common factors to be found in research and promotion costs, the difference in statutory treatment of them compels this discussion to be divided into two parts. Part one will be devoted to promotion costs.

PART I: PROMOTION COSTS

1. Points to Consider

Promotion costs embrace diverse expenses ranging from institutional or goodwill advertising to selling campaigns and entertainment expenses.[3] In the strict sense, "promotion" means advancing or building up business or good will, rather than merely maintaining the status quo. However, the courts have sometimes sensed the achievement of both results concurrently in determining the tax consequences of promotion costs.[4] Accordingly, cognizance of this fact will be taken in the analysis that follows. It should be noted that circulation expenditures are given special treatment under Section 173 of the Internal Revenue Code of 1954.

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[1] Jacob Rabkin and Mark H. Johnson, *Federal Income, Gift, and Estate Taxation,* 1955 edition, Vol. I, p. 358. New York: Matthew Bender and Company.

[2] Judge Sternhagen in *Northwestern Yeast Co.*, 5 B.T.A. 233 (1926).

[3] See J. K. Lasser, *Handbook of Accounting Methods*, page 168. New York: D. Van Nostrand Company, Inc., 1943.

[4] It is to be noted that in several invested capital cases [*Colonial Ice Cream Co.*, 7 B.T.A. 154 (1927); *Northwestern Yeast Co.*, 5 B.T.A. 232 (1926); *Richmond Hosiery Mills*, 6 B.T.A. 1247 (1927), affirmed 29 F. 2d 262, 7 AFTR 8298 (5 Cir. 1928), cert. den. 279 U.S. 844 (1929); *Howard Hunt Pen Co.*, 10 B.T.A. 900 (1928)] "the allowance of the expenditures [for promotion costs] as invested capital was denied because of the absence of proof that

Assume that your client is planning to conduct some advertising and promotional activities, and that you are called upon to advise him how to obtain the maximum tax benefit from the cost of these activities. Your first question should be:

	Section
Will the business be continued indefinitely or sold (or exchanged with a recognized gain or loss) at a planned future date?	3

Having determined the answer to this question, the problem is to select an advertising and promotional program that will have a purpose consistent with your client's plans for continuation or disposal of the business. This requires analysis along the following lines:

	Section
Will the advertising and promotion maintain good will, sales, or business volume?	2
Will the advertising and promotion increase good will, sales, or business volume?	2
Will they accomplish both ends?	2

Having selected the type of program, the problem is to direct and account for advertising and promotional activities in such a way that the Internal Revenue Service will be satisfied that they are in fact, as well as in your client's planning, consistent with the purpose attributed to them. This involves:

	Section
Study of past history of your client's business	2, 3
Conduct of surveys and compilation of statistical reports fairly showing results of activities	2, 3
Setting up advertising and promotional projects	2, 3

These are essential steps in planning advertising and promotional activities from the standpoint of tax minimization.

2. How to Treat Promotion Costs for Federal Income Tax Purposes

In the chart below, you will find an analysis of promotion costs and their proper tax treatment, based on the principal factor relied on by the courts: the purpose of the promotion activities. The column headed "How to Do It" contains a brief statement of the step or steps to be taken to insure maximum deduction, if de-

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petitioner acquired anything in the way of a subsisting asset. However, in cases arising under § 162 involving ordinary and necessary business expenses the shoe is on the other foot and it is necessary to prove that the taxpayer did not acquire anything in the way of a subsisting asset. If the payments resulted in the acquisition of a subsisting asset, then the payment must be deductible over the period of years during which the resulting benefit is to be enjoyed, or if the benefit has no determinable life, then no deduction at all may be taken until, possibly, at such time as the taxpayer disposes of the property or liquidates the corporation if the taxpayer is a corporation." Jacob Mertens, *Law of Federal Income Taxation,* Vol. IV, § 25.38, footnote 94. Chicago: Callaghan and Company, 1954.

PROMOTION COSTS

Purpose	*What to Do*	*How to Do It*
(1) Maintain good will.	Deduct currently.[5]	As ordinary and necessary business expense.
(2) Establish or increase good will.	Capitalize.[6]	Set up promotion project for this specific purpose; or purchase tangible assets and depreciate.
(3) Maintain sales or business volume.	Deduct currently.[7] (Capitalize if advertising medium lasts beyond current year.)	As ordinary and necessary business expense. (Amortize cost of capitalized advertising medium.)
(4) Increase sales or business volume (for current taxable year).	Deduct currently.[8] (Capitalize if advertising medium lasts beyond current year.)	As ordinary and necessary business expense. (Amortize cost of capitalized advertising medium.)
(5) Establish or increase sales or business volume (permanently).	Capitalize, except in case of circulation costs of publishers, which may be deducted.[9]	Set up promotion projects for each trade mark, trade brand, or trade name and capitalize; or purchase tangible assets and depreciate.
(6) Both maintain and increase sales or business volume.	Allocate costs and (a) capitalize and (b) deduct currently allocated portions.[10]	Set up promotion projects, make surveys of effects, and compile statistics.
(7) Accomplish an isolated sale.	(a) If successful, deduct currently.	As ordinary and necessary business expense.[11]
	(b) If unsuccessful, deduct currently.	As loss.[12]
	(c) If results indeterminate, capitalize.	Set up a "selling project." [13]
(8) Obtain long term contract(s).	(a) If successful, allocate and capitalize.	According to relative values of the contracts.[14]
	(b) If unsuccessful, deduct currently.	As loss.[15]
	(c) If results indeterminate, capitalize.	Set up project for each contract towards which promotion activities have been directed.[16]

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[5] 1954 IRC § 162; I.T. 3581, 1942-2 C.B. 88; I.T. 3564, 1942-2 C.B. 87; I.T. 3593, 1942-2 C.B. 90. Expense of show horses used as a medium of advertising has been allowed where the taxpayer's showing overcame the government's assertion that it was a hobby expense. *Rodgers Dairy Co.*, 14 T.C. 66 (1950).

[6] A. M. *Oliver*, par. 42,567 Prentice-Hall Memorandum T.C., 1942. (Expenditures of a lawyer in acquisition of good will were required to be capitalized); Mertens, *op. cit.* § 25.38, footnote 96. See also Reg. 112, § 733-2 (1944), which presents the Internal Revenue Service position relative to capitalizing expenditures for advertising, or the promotion of good will in connection

duction is to be had. The discussion in paragraph 3 sets forth matters to be considered in planning the promotion activities giving rise to those steps.

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with computation of base period income for excess profits tax purposes.

[7] 1954 IRC § 162; Reg. 118, § 39.23(a)-1 (1953). In *E. H. Sheldon and Co.* v. *Commissioner* (6 Cir. 1954), 214 F. 2d 655, it was held (reversing the Tax Court) that the cost of catalogs published every few years was an ordinary and necessary expense, notwithstanding these were used as the basis of orders over long periods of time. See also *Glenmore Distilleries Company, Inc.*, 47 B.T.A. 213 (1942) (Taxpayer allowed deductions of $177,982.56 for 1937 and $242,890.70 for 1938, representing cost of advertising its brands of liquor in national magazines such as *Life, Collier's, Time,* and *The New Yorker*); *Commercial National Insurance Co.*, 12 B.T.A. 655 (1928) (To extent that expenditures maintained the number of insured or the list of policyholders, they were ordinary and necessary business expenses); *Alexander McLaren*, par. 32,308 Prentice-Hall Memorandum B.T.A. 1932. (Consistent practice of charging off in the following year expense incurred in previous year held insufficient to warrant Board's disregarding express requirement that net income must be computed with respect to a fixed period of twelve months, notwithstanding that such expense was incurred for the purpose of making sales in the following year.) The so-called "circulation cases" are also in point. *Perkins Bros. Co.* v. *Commissioner* (8 Cir. 1935), 78 F. 2d 152, 16 AFTR 326. (Newspaper company's expenditures for carrying on normal business of soliciting subscriptions to maintain circulation structure previously built up to normal or saturation point, held deductible as ordinary and necessary business expenses, even though there was an "incidental" increase in the number of subscribers); *Successful Farming Publishing Company*, 23 B.T.A. 150 (1931), affirmed (8 Cir. 1933) 64 F. 2d 890, 12 AFTR 467. (Cost of maintaining a circulation structure once established is an ordinary and necessary business expense.) But see O.D. 394, 2 C.B. 12 (1920). ("Advertising and sales promotion are not a part of the necessary expenses of Government contracts, and are not proper deductions from the gross income derived from Government sales.")

[8] *Transamerica Corporation* v. *United States* (Ct. Cls. 1946) 65 F. Supp. 470, 34 AFTR 1462; *Aptos Land and Water Co., Inc.*, 46 B.T.A. 1232 (1942); *Mitten Management, Inc.*, 29 B.T.A. 469 (1933).

[9] *X-Pando Corporation*, 7 T.C. 48 (1946); *Liberty Insurance Bank*, 14 B.T.A. 1428 (1929). The underlying theory is that expenditures which have a useful life extending substantially beyond the taxable year should be capitalized in order more clearly to reflect income. Reg. 118, § 39.41-3(b) (1953). Expenditures made for the purpose of eliminating competition fall in the same category and should be capitalized. *Newspaper Printing Company* v. *Commissioner* (3 Cir. 1932), 56 F. 2d 125, 10 AFTR 1292. See *Northwestern Yeast Co.*, 5 B.T.A. 233 (1926). Sec. 204 (a) of the Revenue Act of 1950 added Sec. 23(bb) (1954 Sec. 173) of the Internal Revenue Code, which allows publishers of newspapers, magazines and other periodicals to currently deduct expenditures to maintain, *establish or increase* circulation. A publisher may instead elect to capitalize expenditures which formerly had to be capitalized. In such case, however, the election must be for the total amount of such portion of the circulation costs as is chargeable to capital account, and shall be binding for all subsequent years. Publishers who have improperly charged off capital-type circulation expenditures in prior years can now rest more comfortably, because the amendment was retroactive to January 1, 1946.

[10] *The Journal of Living Publishing Corporation*, 3 T.C. 1058 (1944); *Cohan* v. *Commissioner* (2 Cir. 1930), 39 F. 2d 540, 8 AFTR 10552. Most of the decisions recognize the rule, but hold against the taxpayer because of lack of adequate evidence. *Houston Natural Gas Corporation* (4 Cir. 1937), 90 F. 2d 814, 19 AFTR 932; *Three-In-One Oil Co.* v. *United States* (Ct. Cls. 1929), 35 F. 2d 987, 8 AFTR 9817; *Colonial Ice Cream Co.*, 7 B.T.A. 154 (1927). See also Reg. 112 § 733-2 (1944). In case of circulation costs, see note 9, supra.

[11] 1954 IRC § 162 or 212, as the case may be. Where there is a casual sale of personalty or realty on the installment basis, special treatment is provided for by 1954 IRC § 453.

[12] 1954 IRC § 165. See *Warner Mountains Lumber Company*, 9 T.C. 1171 (1947) (Refusing to permit taxpayer to capitalize amounts paid for unsuccessful efforts to sell real estate.)

[13] This represents an investment in future income which should be charged to capital account. Reg. 118, § 39.41-3(b) (1953); *Alford J. Williams, Jr.*, 29 B.T.A. 892 (1934). See *The Pittsburgh & West Virginia Railway Company*, 9 T.C. 268 (1947).

[14] *United Profit-Sharing Corporation* v. *United States*, 66 Ct. Cls. 171, 6 AFTR 7850 (1928).

[15] 1954 IRC § 165.

[16] Each project represents an investment in future income which should be charged to capital account. Reg. 118, § 39.41-3(b) (1953); *United Profit-Sharing Corporation* v. *United States*, 66 Ct. Cls. 171, 6 AFTR 7850 (1928). See *Alford J. Williams, Jr.*, 29 B.T.A. 892 (1934); *The Pittsburgh & West Virginia Railway Company*, 9 T.C. 268 (1947), rev. on other issues (3 Cir. 1949) 172 F. 2d 1010.

3. Planning Promotion Activities

Knowing what the rules are, we have the problem of taking the steps necessary to insure that the Internal Revenue Service or the courts will apply them to your case.

a. How to get deductions for maintaining good will. Where the purpose of promotion costs is to maintain good will, the policy of the Internal Revenue Service in favor of allowing "reasonable" amounts of such costs to be currently deducted is set forth in I.T. 3564,[17] which ruled upon the deductibility of expenditures for advertising by taxpayers engaged in war production. Here the Internal Revenue Service recognized that the cost of maintenance of trade names and reputation of quality of products and good will built up over past years is currently deductible. It warned that there is no definite rule for determining what amounts are reasonable for this purpose, stating that "it is necessary to take into consideration all the facts and circumstances in each particular case." However, such factors as (1) the size of the business, (2) the amount of prior advertising budgets, (3) the public patronage reasonably to be expected in the future, and (4) the increased cost of the elements entering into the total of advertising expenditures, are listed as pertinent. Although I.T. 3564 was issued for the purpose of clarifying official policy with respect to wartime advertising, the principles are equally sound in time of peace. If a taxpayer has for many years consistently deducted "reasonable" sums expended for the purpose of maintaining good will, the Internal Revenue Service will no doubt continue to permit such deductions. However, in the absence of such long-continued practice, a taxpayer runs the risk of a determination that such costs represent build-up and not mere maintenance of good will. In such a case, it might be both difficult and expensive to prove the contrary. Accordingly, it would be sounder to design promotion costs for the purpose of maintaining sales or business volume rather than for the purpose of maintaining good will.

b. How to handle costs of increasing good will. Where the purpose of promotion costs is to establish or increase good will, the taxpayer will ordinarily have decided that no current deduction for such costs is desired. The implication is that basis is to be increased for the purpose of decreasing gain or increasing loss from the sale or exchange of the business as a whole, or some phase thereof. In the latter case, it would be well to set up a specific promotion project directed at building up the good will of the particular phase of the business that will be disposed of. For example, if a taxpayer has several divisions of its business (W, X, Y, and Z), but intends to dispose of only the Y Division, the promotion project should be directed exclusively toward building up the good will of the Y Division.[18] If a taxpayer should desire to establish or build up good will (as distinguished from sales or business volume), and at the same time obtain a current deduction for such costs, the only solution will be to acquire physical assets, e.g. signs and take depreciation deductions for their useful life.

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[17] 1942-2 C.B. 87.

[18] Reg. 112, § 733-2 (1944) provides: ". . . the following expenditures may in any case be regarded as capital investments within the contemplation of section 733:

(a) All advertising expenditures to promote a taxpayer's business in a territory new to such taxpayer, or to promote a new . . . department . . . for the first 12 months after the taxpayer has begun to develop such new territory, or to promote such new . . . department . . ."

c. How costs to maintain sales or business volume are deducted. Where the purpose of promotion costs is to maintain sales or business volume, the costs are deductible as ordinary and necessary business expense. However, the purpose must correspond to the evidence. In the first place, you should be prepared to prove that the amount of promotion costs bears a reasonable relation to the volume of sales or business transacted.[19] And in the second place, you may be reasonably certain that any appreciable increase over the previous year's promotion costs will have to be justified on the basis of higher costs of promotion services, or will have to be related directly to an increase in sales or business volume confined to the current taxable year.[20] Where the purpose of promotion costs is to increase sales or business volume during the current taxable year only, promotion activities should be limited to products or services that have few, if any, repeat customers from one year to the next. Otherwise, the Internal Revenue Service can probably effectively determine that some or all of such costs should be capitalized.[21]

d. How to handle costs of increasing sales and business volume. Where the purpose of promotion costs is to establish or increase sales or business volume for a period extending substantially beyond the taxable year, the costs must be capitalized. If no current deduction for such costs is particularly desired, separate promotion projects should be set up for each trade mark, trade brand, trade name, and so forth. Then, if the project becomes a failure during the taxable year, you will be able to prove how much the actual loss amounts to.[22] If the trade mark, trade brand, or trade name is sold, the basis can be increased by the amount of the cost of the promotion project. On the other hand, if a current deduction is desired, promotion activities should be directed at acquiring physical assets, such as signs, so that deductions for depreciation can be taken over the life of such assets.[23] Beware of seemingly plausible business accounting approaches to the problem of capitalizing and amortizing promotion costs. They are usually of little value for Federal income tax purposes.[24]

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[19] If the amount is so large as noticeably to reduce or eliminate profit, you run the risk of having the Internal Revenue Service determine, in the absence of other mitigating factors, that the amount was excessive and unreasonable. See *Shasta Water Co.*, 1942 P-H Board of Tax Appeals Mem. Dec. Serv., par. 42,077, for an example of a "mitigating circumstance," where parent corporation's reimbursement of an operating loss of a subsidiary (used as an advertising medium) was held properly deductible by the parent corporation.

[20] Two courts have liberally remarked that an "incidental" increase in business would not transform an otherwise current business expense into a capital expenditure. *Perkins Bros. Co.* v. *Commissioner* (8 Cir. 1935), 78 F. 2d 152, 16 AFTR 326; *The Journal of Living Publishing Corporation*, 3 T.C. 1058, 1060 (1944). Such a statement will be helpful to the taxpayer, however, only in direct proportion to the evidence that such increase was "incidental."

[21] It is believed that the opinion in *Transamerica Corporation* v. *United States* (Ct. Cls. 1946), 65 F. Supp. 470, 34 AFTR 1462, is too liberal (in favor of the taxpayer) to constitute a safe precedent, particularly in view of the unusual facts of that case. See note 8, supra.

[22] *Edward A. Miller*, 20 B.T.A. 379 (1930), where the taxpayer expended $3,278 in promoting a new periodical which was discontinued during the same year.

[23] In *Liberty Insurance Bank*, 14 B.T.A. 1428 (1929), the taxpayer was permitted to depreciate novelty banks, used to build up its business, over a four year period. See also *Archibald* v. *Simonson*, par. 46,197 Prentice-Hall Memorandum T.C. 1946: Depreciation deductions allowed over estimated life of motion picture films used to promote taxpayer's oil drilling equipment.

[24] Consider, for example, the following: "The cost of a major advertising campaign may with

e. How to allocate—where costs are for maintaining and increasing volume. Where the purpose of promotion costs is both to maintain and increase sales or business volume, the problem of effective allocation arises. Promotion activities should be planned with a view forever to preclude any court from saying: "The record is so unsatisfactory and inadequate in regard to those items that it does not justify even a finding of fact in regard to them." [25] It should also be remembered that the court's recognition of the principle of allocation in the *Three-In-One Oil* case,[26] the *Houston Natural Gas* case,[27] and the *Northwestern Yeast* case[28] did not keep the decisions from going against the taxpayer where there was no proof of how much was spent to retain old customers and how much to obtain new ones. What should be done is to set up separate promotion projects, directed at either retaining old business or building up new business—but not both! In the case of a publishing business, for example, the cost of sending notices of dates for renewal of subscriptions and of follow-up notices would clearly be directed at retaining old customers and would therefore be currently deductible; whereas the cost of mailing notices of trial offers and the like would be directed at new customers and would have to be capitalized, at least to the extent that total circulation was increased.[29] If it is not feasible to break promotion activities down into projects, the next best thing is to compile statistics showing what effect the promotion activities had on old and new business, respectively. Mere increase in sales volume over the preceding year would not assure Internal Revenue Service approval of a plan to capitalize a corresponding proportion of the promotion costs and to charge off the rest. Precise wording of the advertisements would be relevant, as would be the geographical distribution of the promotion activities. Professional surveys should be considered for the purpose of obtaining data regarding the proportion of old customers to new customers making purchases, thus providing a statistical basis for allocation of promotion costs.

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some reason be spread over the operating accounts of several periods on the ground that the charge is clearly in part a cost of revenues accruing in later periods, even if it is impossible to correlate the particular expenditure with the particular revenue resulting therefrom. Kester [author of *Advanced Accounting*, New York, The Ronald Press, 1933] holds that conservatively calculated 'excess expenditures' for advertising should be capitalized but that 'instead of recording them as good will . . . they should be carried as prepaid advertising and written off rapidly over the next two or three years.'" W. A. Paton, *Accountants' Handbook*, third edition, page 848. New York: The Ronald Press Company, 1943.

Circulation costs of publishers of newspapers, magazines and other periodicals are deductible under Sec. 173 of the Internal Revenue Code of 1954. This is so notwithstanding that the costs are for the purpose of establishing or increasing, rather than merely maintaining, circulation. However, no deduction is allowed for expenditures for land or depreciable property used for this purpose. Publishers may elect to capitalize such circulation costs as would be properly chargeable to capital account were it not for Sec. 173. Once made, the election must be for all amounts so chargeable and is binding for all subsequent years.

[25] *F. Byron Todd*, par. 48,203 Prentice-Hall Memorandum T.C. 1948.

[26] *Three-In-One Oil Co.* v. *United States* (Ct. Cls. 1929), 35 F. 2d 987, 8 AFTR 9817.

[27] *Houston Natural Gas Corporation* v. *Commissioner* (4 Cir. 1937), 90 F. 2d 914, 19 AFTR 932.

[28] *Northwestern Yeast Co.*, 5 B.T.A. 233 (1926).

[29] In *The Journal of Living Publishing Corporation*, 3 T.C. 1058 (1944), the court allocated the cost of new subscriptions between expense and capital according to the number of subscriptions required to replace those lost during the year and the number by which the circulation structure was increased.

Mere spotty guesswork will not satisfy the Internal Revenue Service, much less the courts.

f. How to handle promotion costs of an isolated sale. Where the purpose of promotion costs is to accomplish an isolated sale, the costs are currently deductible as ordinary and necessary expense if the sale is accomplished during the current taxable year. If the results are clearly unsuccessful, the costs of promotion are also currently deductible—although more properly under the theory of loss than expense. If the results are indeterminate, the taxpayer enters a twilight zone of uncertainty: if he seeks to deduct the costs currently, he runs the risk of a determination that he has made an investment in future profits which should be capitalized; if he seeks to capitalize the costs, he faces a possible court assertion that the "expenditures did not result in the acquisition, development, or improvement of property or create any benefit having a useful life beyond the taxable year in which they were made." [30] In the *Pittsburgh & West Virginia Railway Company* case,[31] the taxpayer set up a project called "Sale of Bridge and Tunnel" on which was spent the sum of $68,068.60 from 1931 to 1939. It sought to charge off this amount in 1941 under the theory that the project was abandoned. The court disallowed the deduction, not because it was improper to have capitalized the expenditures from 1931 to 1939, but because the taxpayer had not proved abandonment of the project. In the *Williams* case,[32] the taxpayer was allowed to deduct $3,000 in 1929, representing expenses of negotiating a sale of real estate (owned by a third party) over the period from 1926 to 1929. The decision would be difficult to justify under any other theory than that the expenses represented an investment in future profits which should be capitalized and charged off in the year (or years) in which such profits were received in order clearly to reflect income. With meager authority on which to proceed, then, it appears that in the case of an isolated sale, promotion costs having indeterminate results should be capitalized to insure the best chance of ultimate deduction.

g. How to handle promotion costs of long-term contracts. Where promotion costs are directed at obtaining one or more long-term contracts, the same treatment as in the case of an isolated sale is indicated, except in those instances where promotion activities meet with success in the current taxable year. In such cases, there has been an investment in future profits which should be amortized over the life of the contracts instead of deducted as an ordinary and necessary expense. The taxpayer in the *United Profit-Sharing* case[33] proposed three methods of amortizing such costs: (1) to spread the expenditures over the life of the longest contract, which had a life of ten years; (2) to spread them over the average lives of the contracts, which was 6.94 years; or (3) to allocate to each contract such proportion of the total promotion costs as the returns under each contract bore to the returns expected from all contracts. The last method appealed to the Court of Claims as the "best means for the fair and equitable amortization" of the expenditures, so it might be well for you to adopt it.

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[30] *Warner Mountains Lumber Company,* 9 T.C. 1171 (1947).

[31] 9 T.C. 268 (1947), rev. on other issue (3 Cir. 1940) 172 F. 2d 1010.

[32] 29 B.T.A 892 (1934).

[33] *United Profit-Sharing Corporation* v. *United States,* 66 Ct. Cls. 171, 6 AFTR 7850 (1928).

PART II: RESEARCH COSTS

1. Points to Consider

Section

Election to deduct 2
Election to amortize 3
How to capitalize research costs 4
Costs not subject to elections 5
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2. Election to Deduct

Under the Internal Revenue Code of 1954, taxpayers are given an election currently to deduct research and experimental costs instead of capitalizing them.[34] Prior to 1954, the law was indefinite and court decisions usually rested on the issue of whether the taxpayer had an established accounting practice of consistently charging off such costs.[35] This was in line with the policy of the Internal Revenue Service to recognize a taxpayer's established accounting practice.[36] However, where the results were successful and valuable assets were acquired, the taxpayer deducted the costs thereof at his peril.[37]

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[34] IRC (1954) Sec. 174(a). Research and experimental costs are no small item in the American economy. In 1952 they amounted to seven and a half billion dollars, of which over half was paid for by industry (the balance being financed by government, universities, and nonprofit organizations.). Hodgins, "The Strange State of American Research," *Fortune*, April 1955. The new Treasury Department Regulations provide that taxpayers are not permitted to deduct additions to reserves for estimated research and experimental costs under Sec. 462. Regs. 1.462-5(c)(5).

[35] For instances where the taxpayer was able to maintain the issue, see *Ross B. Hammond* v. *J. W. Maloney, Collector* (CA 9th, 1949), 176 F. 2d 780, 38 AFTR 401; *Ohio Loan & Discount Co.* v. *Commissioner*, 3 T.C. 849 (1944); *Reynolds Cattle Co.*, 31 B.T.A. 206 (1934); *Murtha* v. *Schmohl Co.*, 17 B.T.A. 442 (1929); *Towers Warehouses, Inc.*, P-H 1947 T.C. Mem. Dec. Serv., par. 47,013. See also the author's article, "Research and Development Costs," *Proceedings of New York University Seventh Annual Institute on Federal Taxation*, pages 134-151. New York: Matthew Bender and Company, 1948. Originally the Commissioner's regulations permitted a taxpayer to currently deduct expenses for "designs, drawings, patterns, models, or work of an experimental nature calculated to result in improvement of his facilities or his product." Treas. Regs. 45, 62, and 65, Art. 168 (1921-1924). However, in 1925 the Board of Tax Appeals held that such costs were capital expenditures and, therefore, not currently deductible where they resulted in the acquisition of additional assets, such as patents. *Gilliam Manufacturing Company*, 1 B.T.A. 967 (1925); *Goodell-Pratt Company*, 3 B.T.A. 30 (1925). Thereupon the Treasury withdrew the option.

[36] Statement of Commissioner of Internal Revenue Dunlap before the Joint Committee on Internal Revenue Taxation, 1952 P-H Fed. Tax Serv., par. 76,233. There were two reasons for this policy: (1) It is most difficult to determine the specific costs applicable to various projects and processes, or to determine in advance the actual cost of a successful research and development project. For example, many projects take as long as ten years or more to develop; some turn out to be unsuccessful; some are not patentable; many of them are going on at the same time, with various scientific and technical people working on different phases of all of them at the same time. (2) The net tax effect over a period of years of allowing current deduction of such expenditures instead of requiring them to be capitalized and allowing deductions later for abandonment of unsuccessful projects and for depreciation on successful ones would not be material.

[37] For instances where the taxpayer lost because results of research and development activities were successful, see *Gilliam Manufacturing Company*, 1 B.T.A. 967 (1925) (cost of developing

The election is to be made for the first taxable year in which such expenditures are paid or incurred beginning after December 31, 1953, evidenced by a statement attached to the return that the taxpayer "has elected under the provisions of section 174(a)(2)(A) to treat all research and experimental expenditures as deductible expenses not chargeable to capital account." The election is binding for all subsequent years unless a consent to make a change is obtained from the director of internal revenue for the district in which the return is filed. An illustration of this point is given in the Senate Finance Committee's report, where a taxpayer having elected to currently deduct regularly incurred research costs requests authorization to capitalize the costs of a special project, so that they can be depreciated or amortized.[38]

3. Election to Amortize

Where the taxpayer does not elect to treat research costs as currently deductible *which otherwise would have to be capitalized,* he may elect to treat such costs as deferred expenses and amortize them over a period of not less than 60 months (beginning with the month in which he first realizes benefits from such expenditures).[39] This election applies only in the case of costs having an *indeterminate* useful life, and if the property resulting from such costs has a determinable useful life the capitalized costs must be deducted over the period of such useful life.[40]

The election is to be made not later than the time prescribed for filing the return (including extensions) for the year in which such costs were paid or incurred. It should be emphasized that an election to currently deduct costs *which otherwise would have to be capitalized* precludes an election to amortize—even during the same taxable year in which the election to currently deduct is made, unless consent to amortize is received from the Director of Internal Revenue. On the other hand, where the research costs in prior years have been of a nature permitting their current deduction (e.g., because the results were unsuccessful

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patents); *Goodell-Pratt Company,* 3 B.T.A. 30 (1925) (cost of developing new tools, patents, secret processes, methods of manufacture, and special machinery); *The Beaumont Company,* 3 B.T.A. 822 (1926) (cost of developing patents); *Dempster Mill Manufacturing Company* v. *Burnet,* 46 F. 2d 604, 9 AFTR 797 (App. D.C. 1931) (advances to subsidiary for experimental purposes); *John F. Canning,* 29 B.T.A. 99 (1933) (cost of experimental and testing activities in developing a formula); *Forest Products Chemical Company,* 29 B.T.A. 638 (1933), affirmed without written opinion (CA 6th 1954), cert. den. 294 U.S. 726 (1935) (cost of sending corporation's president and a chemical engineer to Europe to investigate a process for producing acetic acid); *Claude Neon Lights, Inc.,* 35 B.T.A. 424 (1937) (laboratory expense and engineers' salaries); *Magnetic Analysis Corporation,* 1943 P-H T.C. Mem. Dec. Serv., par. 43,180 (cost of developing machines for magnetic testing of steel); *Viber Company, Ltd.,* 1944 P-H T.C. Mem. Dec. Serv., par. 44,332 (experimental costs resulting in patents). See also *Illinois Central* R.R. Co. v. *Interstate Commerce Commission,* 206 U.S. 441 (1906), where the Supreme Court said that expenditures for permanent-type improvements should not be charged wholly against the operating revenues for a single year: *Joseph W. Price, 3d,* "Some Accounting Problems of Manufacturers," *Proceedings of New York University 11th Annual Institute on Federal Taxation,* 231, 238.

[38] P-H 1954 Internal Revenue Code Service, page 24,259.

[39] IRC (1954) Sec. 174(b). Sec. 1016(a)(14) requires a corresponding adjustment in basis for such amortization deductions, but only where a tax benefit was received therefrom.

[40] Sen. Fin. Comm. Rept., P-H 1954 Internal Revenue Code Service, page 24,529.

or the research was of a general or "institutional" character), the fact that the taxpayer has consistently deducted them should not preclude him from the election to amortize later on in an appropriate case.

4. How to Capitalize Research Costs

Although a taxpayer's method of capitalizing research costs must be in line with the requirement of Sec. 446 that it "clearly reflect income," the Internal Revenue Service and the courts have been inclined to follow business accounting principles when passing on methods of capitalizing and amortizing research costs. The preferred method is to set up separate research projects and to maintain accurate cost records for each. However, where this is not feasible, the total cost of research during the year (either inclusive or exclusive of general or "institutional" research) may be allocated to such projects as have been conducted during the year,[41] the allocation being on an equal basis or, perhaps, according to the relative importance of each project.[42] Another method is to lump all research costs together and charge them off over one of the following periods:

The life of the principal patent[43]

Seventeen-year life of any patents obtained as a result of the research and development[44]

The average life of any outstanding patents benefited by the research and development[45]

Average useful life of any unpatented inventions developed or improved by the research

Life of a contract for products resulting from the research and development.

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[41] The author has personal knowledge of at least one instance where the Internal Revenue Service allowed depreciation of patents on an aggregate basis because of the difficulty of attributing basis to particular patents.

[42] See *United Profit-Sharing Corporation* v. *United States*, 66 Ct. Cls. 171, 6 AFTR 7850 (1928), where capitalized advertising costs were allocated to various contracts obtained as a result of the advertising, according to the size of the contracts. Each allocated portion was then amortized over the life of the contract to which it had been allocated.

[43] *Individual Towel and Cabinet Service Co.*, 5 B.T.A. 158 (1926); *Hazeltine Corporation* v. *Commissioner*, 89 F. 2d 513 (CA 3d, 1937), 19 AFTR 387.

[44] *Magnetic Analysis Corporation*, 1943 P-H TC Mem. Dec. Serv. Par. 43,180. The problem may arise over what to do when, as of the end of the year, the research has been completed but no patent has been issued to the taxpayer. The answer is that no depreciation is allowable because it is not possible to accurately estimate the life of the asset (the hoped-for patent). See Reg. 118, Sec. 39.23(1)-8 (1953). When and if the patent issues, the taxpayer may commence amortization. See *March* v. *Nichols, Shepard & Co.*, 128 U.S. 605 (1888). Amortization over a 60-month period would seem to be in order, however, if an election has been made under Sec. 174(b).

[45] *Mitchel Camera Corporation*, 1947 P-H TC Mem. Dec. Serv. Par. 47,172, affirmed *per curiam* 169 F. 2d 412 (CA 9th 1948). See *Simmons Co.*, 8 B.T.A. 631 (1927), where the taxpayer purchased 113 patents in one group and was allowed an annual deduction for depreciation according to this formula:

$$\frac{\text{Amount of deduction}}{\text{Total cost of patents}} = \frac{\text{Life of patents, as of date group was purchased, expiring during the taxable year}}{\text{Total unexpired life of group on date the group was purchased}}$$

5. Costs Not Subject to Elections

The 1954 Code specifically states that the elections provided shall not apply to costs of acquiring or improving land or property to be used in connection with research or experimentation; nor do they apply to exploration expenditures covering deposits of ore or other minerals, including oil and gas.[46]

6. Area of Uncertainty

An area of uncertainty exists in the case of research activities designed to *maintain* sales or business volume. In none of the court decisions involving treatment of research costs does it appear that the court was presented with an argument that the taxpayer's purpose was merely to maintain sales or business volume by keeping abreast of competition. There have been some interesting coal mine cases in which expenditures resulting in the acquisition of assets having a life extending substantially beyond the taxable year (e.g., electric locomotives, mine cars, and steel rails) were held to be currently deductible because they merely enabled the mine to maintain normal output.[47] The tests prescribed for determining whether such expenditures represented the cost of increased earning capacity and were therefore to be capitalized were: (1) Did they increase output? (2) Did they decrease cost of production? (3) Did they add to the value of the plant? An affirmative answer to any of these questions precluded deduction of the expenditures. It is probable that there are research costs which have resulted in development or improvement of a product, process, and the like, without an accompanying increase in sales, decrease in cost of production, or increase in normal value of plant because such development or improvement was required to enable the taxpayer to merely preserve its competitive balance. Here is where an established method of accounting of the taxpayer, under which such costs of "institutional research" have been currently deducted, should not be binding with respect to subsequent years in which the taxpayer seeks to capitalize research costs designed to substantially improve its competitive situation.[48] However, neither the Code itself nor the committee reports[49] make any attempt to define what is meant by "experimental expenditures which are . . . chargeable to capital account." Therefore, to play safe, obtain clearance from the director of internal revenue before adopting any hybrid method or departing from a method of deducting costs of "institutional research" and seeking to capitalize the costs of a particular project.

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[46] IRC (1954) Sec. 174(c) and (d). The treatment of exploration expenditures is covered separately by Sec. 615 which, with certain limitations, allows the taxpayer an election to deduct an amount up to $100,000 paid or incurred during the taxable year prior to the development stage which otherwise would have to be capitalized. Costs of acquiring or improving land or property to be used for research and subject to allowances for depreciation or depletion must be capitalized, but the Code provides that such allowances shall be considered as expenditures currently deductible under Sec. 174(a) or amortizable under Sec. 174(b). This provision is not clear in its import, but one application can be envisaged: Where a taxpayer has elected to capitalize and amortize research costs, his allowances for depreciation of property (or depletion, as the case may be) *must* be spread over at least 60 months.

[47] *Marsh Fork Coal Company* v. *Lucas*, 42 F. 2d 83 (CA 4th, 1930), 8 AFTR 11046; *United States* v. *Roden Coal Co.*, 39 F. 2d 425 (CA 5th, 1930), 15 AFTR 563; *Commissioner* v. *Brier Hill Collieries*, 50 F. 2d 777 (CA 6th, 1931) 10 AFTR 103. See also *Journal-Tribune Publishing Company* v. *Commissioner*, 216 F. 2d 138 (CA 8th, 1954).

[48] In 1952 the Commissioner of Internal Revenue indicated that the policy of the Internal Revenue Service was to not disturb an *established method of accounting* under which costs of research and development in the "experimental or laboratory sense" were currently deducted. In the case of an airplane manufacturer, such costs were described as salaries of engineers working on development of experimental planes, cost of materials used in construction of experimental planes, and the cost of test flights. Statement of Commissioner Dunlap before the Joint Commit-

7. What to Do

In the chart below, you are advised how to treat research costs under the method of accounting you have elected according to the nature of the results of your research activities.

RESULTS	IF YOU HAVE ELECTED TO DEDUCT ALL COSTS	IF YOU HAVE ELECTED TO CAPITALIZE AND AMORTIZE[50]	IF YOU HAVE ELECTED TO CAPITALIZE SPECIFIC PROJECTS[50]
Successful and determinable	deduct	capitalize over life of property or project	capitalize over life of property or project
Successful and indeterminate			
a. specific project	deduct	amortize over at least 60 months	amortize over at least 60 months
b. several projects	deduct	amortize over at least 60 months	amortize over at least 60 months
c. general or "institutional"	deduct	deduct or amortize (consistently)	deduct or amortize (consistently)
Unsuccessful	deduct	deduct[51]	deduct[51]
Unfinished	deduct	amortize over at least 60 months	amortize over at least 60 months or capitalize in suspense account (consistently)
Acquisition or improvement of land or property	capitalize	capitalize	capitalize

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tee on Internal Revenue Taxation, 1952 P-H Fed. Tax. Serv. Par. 76,233. An exception pointed out was the "costs of obtaining patents," but in view of his other statements it appears that Commissioner Dunlap would have included only the various government and attorney fees in such "costs." *Cf.* Reg. 118, Sec. 39.23(1)-7 (1953), which includes the cost of experimental models and development or experimental expenses as part of the "cost" of a patent for depreciation purposes.

[49] See Footnote 38.

[50] If at all practicable, set up research projects and keep reasonably accurate cost records for them so that, should the occasion arise, you will be able to prove how much of the research costs should be capitalized onto each patent, invention, process, product, and so on, and how much should be charged off if the research activities result in failure. For an excellent example

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of a case in which extensive cost records were maintained, see *Addressograph-Multigraph Corp.*, 1945 P-H T.C. Mem. Dec. Serv. Par. 45,058. Note particularly at page 45 of the case report how a research project was set up. If it is not practicable to break down the research activities into projects, make a scientific allocation of the costs to the patents, inventions, processes, products, and so forth benefited by such activities. For an example of this method of treatment, see *Universal Oil Products Co.* v. *Campbell*, (D.C. Ill. 1948), 40 AFTR 1328, appealed on other issues, 181 F. 2d 451 (CA 7th, 1951).

[61] IRC (1954) Sec. 165. However, you must be able to prove abandonment or absolute failure during the taxable year. *Lanova Corp.*, 17 T.C. 1178 (1952) (no working license agreements resulted); *Homer L. Strong*, 14 B.T.A. 902 (1929) (failure of experiments); *Perine Machinery Co.*, 22 B.T.A. 450 (1931) (abandonment of project). Merely charging off the cost of a project on the books will not suffice. *Portland General Electric Co.*, 1947 P-H T.C. Mem. Dec. Serv. Par. 47,299. Deduction must await some identifiable event signifying failure or abandonment, such as scrapping of an experimental model and destroying the drawings, or a memorandum of a decision by corporate officers. *Dresser Manufacturing Co.*, 40 B.T.A. 341 (1939) (abandonment of experimental engine); *Acme Products Co., Inc.*, 24 B.T.A. 194 (1931) (abandonment of efforts to develop processes). If additional work is to be performed in a later year, and if hope for ultimate success is not unreasonable, there has not been "abandonment." *Cf. Hart-Bartlett-Sturdevant Grain Co.*, 12 T.C. 760 (1949), aff'd. 182 F. 2d 583 (CA 8th 1950) (no abandonment of experimental work); *Morton Frank*, 20 T.C. 511 (1953) (expenses of investigating business opportunities held not deductible because taxpayer was not engaged in a business).

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33

How a Business Can Get Maximum Deductions for Contributions

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1. Points to Consider

Individuals, and particularly business enterprises, will, as a practical matter, often tend to combine their charitable desires with proportionate tax advantage. It is the purpose of this chapter to comment upon such relatively beneficial tax consequences.

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2. Single Proprietorships

a. Deductions on individual returns. An individual doing business reports his business income and deductions on his individual return. Generally speaking, however, his contributions are governed by Section 170(a)[1] and are considered personal deductions not deductible in arriving at adjusted gross income. The maximum amount permissible for years ending prior to December 31, 1951, is 15 per cent of the adjusted gross. For subsequent years, by reason of 1951 amendments to the tax law, one may deduct 20 per cent of adjusted gross.[2] Under the new code,[3] a special additional deduction of up to 10 per cent may be taken for contributions to churches, a convention or association of churches, tax-exempt educational institutions, and tax-exempt hospitals. However, where the Standard Deduction is used, the contributions may not be deducted elsewhere in the return. Attention is called to the fact that in some cases, contributions may be deductible without limitation under Section 162(a)[4] as business expenses. The Regulations at 39.23(o)-1 provide that "A donation made by an individual to an organization other than one referred to in Section 23(o), [170(a)], which bears a direct relationship to his business and is made with a reasonable expectation of a financial return commensurate with the amount of the donation may constitute an allowable deduction as a business expense." It is to be noted that the exclusion of organizations referred to in Section 170(a) is contained only in the Commissioner's Regulations and not in the Code itself as we will find to be true in the similar provision affecting corporations. Except for donations, which properly come under Section 162(a), as noted above, contributions by the individual are treated the same for tax purposes whether made through his business or personally.

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[1] 1954 IRC § 170(a), 1939 IRC 23(o).

[2] 1954 IRC § 170(b)(1)(B), 1939 IRC § 23(e), as amended (Sec. 4(a) *Pub. Law* 465, July 8, 1952).

[3] 1954 IRC § 170(b)(1)(A), T.D. 6118, 12-30-54.

b. Contributions as business expenses. Decided tax advantages are obtained where contributions qualify as business expenses and are deducted in the business schedule in arriving at adjusted gross income. The limitations of 170(b) are not applicable, since the deduction would then be under Section 162(a). By thus reducing adjusted gross income, the deductible portion of medical expenses is increased, since only medical expenses[5] in excess of three per cent of adjusted gross income is deductible. And, finally, where contributions are properly deducted as business expenses, the taxpayer may also use the optional Standard Deduction[6] in lieu of itemized personal deductions. In this connection, however, for years prior to December 31, 1951, a serious note of warning should be sounded. For such years, the election to use the optional Standard Deduction is irrevocable,[7] and if the Treasury should subsequently disallow such contributions as business expense, it would then be too late to show them as non-business expenses under 170. For years ending after December 31, 1951, the taxpayer may elect to take or not to take the Standard Deduction after the due date of the return.[8]

3. Partnerships

In computing partnership income, no deduction is allowed for contributions except for such as may qualify under Section 162, as in the case of individuals. Any 170 contributions made by the partnership[9] are distributed to the individual partners. Each may include his distributive share in his individual return with any other personal contributions he has made during the taxable year, providing, of course, he itemizes his personal deductions. This has the effect of preventing the partners from getting a deduction for contributions and then using the Standard Deduction on their individual returns.

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[4] 1954 IRC § 162(a); 1939 IRC § 23(a).

[5] 1954 IRC § 213; 1939 IRC § 23(x).

[6] 1954 IRC § 141; 1939 IRC § 23(aa).

[7] 1939 IRC § 23(aa)(3)(C). If the taxpayer does not signify, in the manner provided by subparagraph (A) or (B), his election to take the standard deduction, it shall not be allowed. If he does so signify, such election shall be irrevocable.

[8] 1954 IRC § 144, 1939 IRC § 23(aa)(7).

[9] 1954 IRC § 702; 1939 IRC § 183(c).

4. Corporations

a. Corporate authority for contributions. Purely charitable donations by business corporations are *ultra vires* acts unless specifically permitted by the controlling state law.[10] On the other hand, contributions made with the expectation of receiving pecuniary benefit therefrom are held to be within the general provisions granted to corporations.[11] Aside from the deductibility of a particular contribution, therefore, there is first the question of whether or not it was within the power of the corporation to make the donation.

b. To whom can a corporation contribute? The Code permits corporations to deduct contributions to substantially the same beneficiaries as individuals. But the limitation is 5% of net income.[12] However, excess contributions may be carried over, for two years, to the extent provided in Section 170(b)(2).

1. Under Section 882(c)(3),[13] foreign corporations are permitted the deduction under Section 170.

2. With reference to the limitation placed on the maximum amount of contributions allowable under 170(b)(2),[14] there are some interesting exceptions. In computing personal holding company net income, the limitations on 170 deduction are the same as those regarding an individual rather than the 5 per cent imposed on corporations.[15] For purposes of "accumulated taxable income" under Section 535,[16] 100 per cent deduction for contributions described in 170 is allowed.

c. Contributions as business expenses. It is possible that a gift may be deductible under Section 162(a) as a business expense, which would be allowable without limitation.

1. To come under this section, there must be a showing of a direct benefit to the donor corporation commensurate in amount to the gift made. However, the Code[17] provides that no deduction would be allowable under subparagraph (a) to a corporation for any contribution that would be allowable under 170 were it not for the percentage limitations or the requirements as to the time of payment. The Regulations expand this principle in Section 39.23(a)-13.

2. Here again the advantages of bringing contributions under Section 162(a) are obvious. For taxable years prior to January 1, 1936, there was no statutory provision for charitable contributions by corporations. To be deductible, therefore, the contribution had to meet the business test and show a reasonable expectation of

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[10] *Wolter* v. *Johnston* (3 Cir. 1929), 34 F. 2d 598.
[11] *Derr* v. *Fisher*, 98 Pac. 978 (Okla. 1908).
[12] 1954 IRC § 170; 1939 IRC § 23(q).
[13] 1954 IRC § 882; 1939 IRC § 232(b).
[14] 1954 IRC § 170(b)(2); 1939 IRC § 23(q).
[15] 1954 IRC § 545(b)(2); 1939 IRC § 505(a)(2).
[16] 1954 IRC § 535; 1939 IRC § 102(d)(1)(B).
[17] 1954 IRC § 162(b); 1939 IRC § 23(a)(1)(B).

a commensurate return. A number of decided cases[18] passed on the question and presumably they would be valid today on this particular issue. However, in the 1938 Act, the provision was first inserted,[19] which now appears as Section 162(b).[20] The bare language of this subsection would seem to disqualify as a business expense deduction, all contributions to organizations coming within the purview of Section 170.[21] However, it specifically refers to "charitable contributions" or "gifts" and, of course, would not interfere with a business deduction for payment made under contract, even though the payee be one described in Section 170.

5. Methods of Contributing

a. Who should contribute—corporation or stockholder? In the case of controlled corporations, it is apparent that a tax advantage has been achieved in having the corporation make contributions instead of the stockholders. Even though the amount in excess of 5 per cent would not be deductible, nevertheless, in a given case the individual would save the dividend cost to him less the allowance he would receive for his personal contributions, which would be subject to the 20 per cent and 10 per cent limitations of Section 170. This leads to the question of liability under Section 535. The answer is apparently covered in Section 535(b)(2) noted above, which provided for 100 per cent deduction of contributions described in Section 170. The taxpayer must also consider whether or not such contributions would constitute constructive dividends to the stockholders. It is generally considered that where the amount of the gift does not exceed an appropriate proportion of the earnings for the year, and the gift is made solely in the name of the corporation, the contributions would not constitute constructive dividends. This is based on an analysis of pertinent legislative enactments, particularly the provisions relating to Section 535, which permits 100 per cent deduction for contributions and also a deduction for dividends paid, with the result that treatment of contributions as constructive dividends might thus result in a double deduction for the same item.[22]

b. Trusts and foundations. A useful vehicle for corporate contributions is a charitable trust or foundation. Organized as a non-profit corporation and conforming with conditions provided in Section 101(6),[23] it would be exempt from income taxation. If organized as a charitable trust it may easily escape any taxation by virtue of the liberal provisions regarding the unlimited deductions for charitable contributions under Section 142(c).[24] Such trusts or foundations may be availed of by individuals, of course, as well as corporations.

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[18] *Superior Pocahontas Coal Company*, 7 B.T.A. 380 (1927); *Old Mission Portland Cement Co.* v. *Commissioner*, 69 F. 2d 676 (9 Cir. 1934), 13 AFTR 751 affirmed 297 U.S. 289, 14 AFTR 687 (1934); *Commissioner* v. *F. & R. Lazarus Co.*, 101 F. 2d 728 (6 Cir. 1939) 22 AFTR 585, affirmed 308 U.S. 252, 23 AFTR 787 (1939); *American Rolling Mill Co.* v. *Commissioner*, 41 F. 2d 314 (6 Cir. 1930), 8 AFTR 10937.

[19] 1938 IRC § 23(a)(2).

[20] 1954 IRC § 162(b); 1939 IRC § 23(a)(1)(B).

[21] See *B. Manischewitz*, 10 T.C. 1139 (1948) where the court specifically stated that the recipient did not qualify under § 23(q) [1954 IRC § 170] and then found the contribution to be a business expense under § 23(a) [1954 IRC § 162(a)].

[22] J. K. Lasser, "Some Sophisticated Problems with Charitable Deductions," *Taxes*, June, 1948, Vol. 26, pages 548, 550.

[23] 1954 IRC § 501(c)(3); 1939 IRC § 101(6); Section 501(c)(3) provides, "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the

c. Foundations for benefit of employees. It is possible to set up a foundation for the benefit of employees of a single company, provided the designation is by class and not with reference to particular individuals. The following purposes have been suggested:

1. Providing for employees in time of sickness or need
2. Assisting families at time of death
3. Providing pensions for employees, who are retired for reason of sickness or age, and
4. Awarding scholarships to employees on merit system for further training along business or technical lines.

By making regular annual contributions to a single organization, there may be accumulated a substantial sum, even in case of lower income taxpayers, which would permit the accomplishment of larger aims than would be possible if the relatively small annual amounts were applied currently. This is true in the case of foundations, which may hold the receipts until a fund sufficient for the desired purpose has been accumulated. This result may also be achieved through a charitable trust.

d. Pension and profit-sharing plans. In this discussion on contributions of business enterprises, reference, however brief, must be made to the possibility of contributions paid under a stock bonus, pension, profit-sharing or annuity plan for employees. Such payments are in the nature of additional compensation and must meet requirements of 162(a). The deduction on the part of the employer, however, is governed by Section 404 [25] and the plan must qualify under Section 401.

The impulses of an employer seeking to benefit employees as a group may well be exerted in this field, although it is obvious that selectivity, as to individual recipients, will not thus be obtained. Such employers are, in effect, distributing deferred compensation, or, similarly, supplementing Federal and State retirement and unemployment benefits. Broadly speaking, these commendable purposes do credit to the employer but should, technically, be separated from the concept of charity.

e. Accruing charitable contributions. Inasmuch as the majority of business enterprises and most corporations are on the accrual basis, the effect of the 1949 technical changes becomes important.[26] A corporation on the accrual basis has the election each year to deduct contributions accrued during the year. However, payment must be made within 2½ months after the end of the corporation's taxable year. This new law also applies to accumulated taxable income cases and the Personal Holding Company tax. Where an election is made as to a prior year, con-

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benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, and which does not participate in, or intervene in (includng the publishing or distributing of statements), any political campaign on behalf of any candidate for public office."

[24] 1954 IRC § 642(c); 1939 IRC § 162(a).

[25] 1954 IRC § 404; 1939 IRC § 23(p).

sent must also be given to any assessment for any deficiency in that prior year.[26]

With respect to payment by check, the rule laid down in *Estate of John F. Dodge*,[27] was that if payment is by check, the check must be certified or cleared by the bank within the year of deduction. A recent case, *Estate of Spiegel*,[28] reviews the general acceptance, in the business world, of checks, and concludes that where a check is delivered and accepted unconditionally, and subsequently presented and paid in due course, the payment, in effect, relates back to the date of delivery of the check. The Tax Court held that if this case was not distinguishable from the *Dodge* case, then the latter was regarded as erroneous and would no longer be followed. Although there were six dissents in the *Spiegel* case, it has subsequently been followed in the case of *Estelle Broussard*.[29]

f. Contributions of property. Payment may, of course, be made in forms other than cash. For example, issuance of promissory notes of readily ascertainable market value has been construed as constituting a payment for purposes of Section 267(a)(2);[30] so too, where a series of notes are cancelled as they mature, thus spreading the gift over a period of years.[31] Gifts in property other than cash are specifically provided for in the Regulations, Section 39.23(o)-1, which would also be applicable to corporations.

1. Deduction in such cases is measured by the fair market value of the property. An important feature here is that where the market value is greater than the adjusted cost basis, a gift of the property itself is more favorable, taxwise, than selling the asset and turning over the proceeds. If the asset is sold, the capital gain is includible, whereas in a gift of the property, no gain is recognized, despite the fact that the full fair market value, without reference to basis, is deductible. Recent rulings of the Treasury have said that a gain in income of the donor may be realized upon the gift of property which is classed as stock in trade or property held for sale in the customary course of a trade or business.[32] The soundness of this extension of the doctrine of the *Horst* case is questionable,[33] and as yet the Courts have not supported the Commissioner's position. It has been held [34] that the gift of wheat to the Friendship Train, not reported as either a donation or as income, could not be treated as a gift and thus give rise to any taxable income.

In *Campbell* v. *Prothro*,[35] the Court overruled the Commmissioner's contention that the value of a charitable gift of cattle was income to the donor, even though the expense of raising the cattle had been deducted. In a recent case, the Tax Court[36] held that gifts of land and unharvested wheat crops to children were not income realized by the donor. These decisions are, of course, contrary to the Treasury ruling (holding) that such a donation gives rise to income to the extent of the fair market value of the property at the time of the gift. However, in view of the decided cases, it is believed the Courts will continue to overrule the Commissioner.

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[26] 1954 IRC § 170(a)(2); 1939 IRC § 23(q) as amended.

[27] 13 B.T.A. 201 (1928).

[28] 12 T.C. 524 (1949).

[29] 16 T.C. 23 (1951).

[30] 1954 IRC § 267(a)(2); 1939 IRC § 24(c)(1).

[31] *Celina Mfg. Co.* v. *Commissioner*, 142 F. 2d 449 (6 Cir. 1944), 32 AFTR 672; (memorandum decision reversing 47 B.T.A. 967 (1942), ordering Appellee to follow decision in the *Musselman Hub-Brake Co.* v. *Commissioner* (6 Cir. 1943), 139 F. 2d 65, 31 AFTR 1001; *Andrus, et al.* v. *Burnett* (Ct. App. D.C. 1931) 50 F. 2d 332. 9 AFTR 1658.

[32] I.T. 3932, 1948-2 C.B. 7; I.T. 3910, 1948-1 C.B., 15.

[33] *Helvering* v. *Horst*, 311 U.S. 112, 24 AFTR 1058 (1940); Robert N. Miller, "Gifts of Income and Property"; *Tax Law Review*, Vol. 5, pages 1-15.

[34] *David C. White* v. *Broderick* (D.C. Kan., 1952), 104 F. Supp. 213. 41 AFTR 1253.

[35] 209 F. 2d 331 (5 Cir., 1954).

[36] *Elsie SoRelle*, 22 T.C. 459 (1954).

2. Where there is an intention to give income-producing property to a charitable organization, ultimately, as by will in case of an individual, it should be remembered that by delaying the gift, the income therefrom is taxed to the prospective donor. Thus, a present gift will not only provide a present deduction, but will also remove liability for future income.

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How to Get Deductions for Abandonments

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When you have been using an asset in your trade or business and its useful value has been completely extinguished or terminated during the taxable year, you may under certain conditions abandon the asset and claim a deduction from gross income for federal tax purposes. The deduction is usually restricted to loss of value which occurs suddenly and not to loss of value which results from obsolescence or from the failure to claim sufficient depreciation in prior years. The loss of value must be due to an unforeseen cause and must not have been anticipated when the asset was acquired.[1] The extinguishment of useful value must result from an identifiable event and must occur during the taxable period in which the deduction is claimed.

Although the Internal Revenue Code does not expressly authorize deductions for abandonments, referring only to "any loss sustained during the taxable year and not compensated for by insurance or otherwise,"[2] administrative interpretations[3] and judicial decisions authorize deductions from gross income for losses from abandonments, provided the loss is evidenced by a closed and completed transaction and sustained during the taxable period. A study of the various Court decisions and interpretations as a prerequisite will indicate the method for obtaining a deduction from gross income with resulting tax benefits. The method of obtaining a deduction from gross income for the value of business assets abandoned is described in this chapter.

1. Points to Consider

When you, doing business as an individual, or as an elected officer of a corporation, discover that you have a business asset that has lost its useful value, you are, naturally, desirous of obtaining the best tax treatment. Various questions must be answered before a proper solution can be evolved and as an aid to the problem you must have knowledge of or obtain answers to the following questions.

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[1] *S. S. White Dental Mfg. Co.* v. *U.S.* 55 F. Supp. 117.

[2] 1954 IRC § 165(a); 1939 IRC § 23.

[3] Reg. 118, § 39.23(e)-2 and 3.

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2. Who May Claim Abandonment Deductions?

Inasmuch as deductions are permitted when a particular business asset has prematurely lost its useful value and been abandoned, the section of the regulations[4] relating to the deduction of "losses sustained during the taxable year and not compensated for by insurance or otherwise" should be examined to determine the type of taxpayers who may claim abandonment deductions.

You should realize that deductions for losses, whether sustained from abandonment or otherwise, are allowable as a matter of privilege and legislative grace only[5] and not as a right. The requirements relating to deductions for losses, which have been developed entirely by administrative and judicial interpretations, apply to deductions for business assets abandoned.

Taxpayers entitled to claim abandonment deductions may, therefore, be divided into the following four classifications.

Individuals. When you are doing business as an individual you are entitled, under certain conditions, to claim a loss deduction from gross income for business assets which have become worthless within the taxable year and for which you have not been compensated by insurance or otherwise. Such deductions are allowable, however, only if the losses are

1. incurred in a trade or business; or
2. incurred in a transaction entered into for profit, though not connected with the trade or business; or
3. the results of "fire, storm, shipwreck, or other casualty, or from theft," even though the property is not connected with the trade or business.[6]

It should be noted that an asset abandoned must have been used in your trade or business or have been acquired by you in a transaction entered into for profit, if you expect to be successful in claiming a deduction from gross income. In addition, other requirements outlined in this chapter must be satisfied.

Corporations. Should you, as a corporate officer, wish to claim a deduction from gross income for the value of an asset owned by a corporation and abandoned as valueless, both the Code and regulations[7] permit the deduction of "losses sustained during the taxable year and not compensated for by insurance or otherwise."

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[4] Reg. 118, § 39.23.

[5] *O. Ben Haley*, 6 B.T.A. 782 (1927).

[6] 1954 IRC § 165(c); 1939 IRC § 23(e).

[7] 1954 IRC § 165(a); 1939 IRC § 23(f). Reg. 118, § 39.23(f)-1: "Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible in so far as not prohibited or limited by Sections 23(g), 23(h), 24(b), 112, 117, 118, and 251. The provisions of Sections 39.23(e)-1 to 39.23(e)-5, inclusive, and Section 39.23(i)-1 are in general applicable to corporations as well as individuals."

Neither the Code nor the regulations recite, as in the case of an individual, that the loss must be incurred in a trade or business, or in a transaction entered into for profit. Inasmuch as a corporation is a fiction created by law it is presumed that all losses sustained by it are incurred in business transactions.[8]

There are various types of business enterprises which are taxed as corporations even though local incorporation laws have not been complied with. These include Massachusetts trusts, voluntary associations (when more than a joint venture is involved), business, investment, and common-law trusts, joint-stock associations, and partnerships under certain conditions.

Should you be doing business in one of the above types of enterprises, you will be entitled to deduct from gross income the amount of the abandonment loss as though the enterprise had been a corporation.

You should keep in mind, however, that the loss claimed "must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed."

Partnerships. If you are a member of a partnership, you may obtain a deduction from gross income for the value of a partnership asset used for business purposes, provided the asset has lost its useful life and is abandoned. Partnerships, as such, do not pay federal income taxes although they are, for tax purposes, considered separate entities and are required to report income in annual returns.[9] Rules and regulations applicable to individuals apply also to the computation of partnership income.

Although obtaining a deduction from gross income for an abandonment loss directly reduces the partnership net income, there is no direct tax saving accomplished. However, a partnership is considered a mere conduit for the distribution of net income and the allocation of expenses and losses incurred. Losses sustained from the abandonment of partnership assets, therefore, will produce an indirect tax benefit to each of the individual partners.

Other taxpayers. When you are conducting business as one of the other types of taxpayers, such as a trustee, a lessor, an estate, or engaged in a joint venture, you may obtain an abandonment deduction provided the asset abandoned is used in your business and the other factors necessary to substantiate abandonment losses are complied with.

3. What Is Necessary to Constitute Abandonment?

When you wish to obtain an abandonment deduction from gross income you should understand the two elements required to substantiate an abandonment loss. These two elements are:

1. There must be an intention on the part of the owner to abandon the valueless property, and
2. There must be an overt act of abandonment or destruction by the owner of the property.

Both of these elements must be ascertained and determined from all the surrounding circumstances.[10] You should realize that abandonments are difficult to substantiate generally. The burden of proof is placed upon you.

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[8] *Klein* v. *Board of Tax Supervisors,* 282 U.S. 19 (1930).

[9] Form 1065.

As a prerequisite, it is essential that the usefulness of the property be suddenly terminated, that the event was unforeseen, and that the value of the property has been completely extinguished within the taxable year. The sudden termination of usefulness must be distinguished from ordinary or normal decline in value. The former factor is essential to comply with the regulations if you intend to claim an abandonment loss, whereas the latter merely indicates the ordinary wear and tear for which annual depreciation deductions are allowable. Mere shrinkage in value of an asset is not sufficient. The termination of usefulness and value generally arises when there has been a change in the manufacture or cost of a product, and more modern and efficient machinery is required to replace the obsolete and valueless machinery being abandoned. You may elect to abandon the old machinery or equipment in the same year new machinery is purchased,[11] or at any time during the physical life of the particular asset. The loss of useful value does not refer to the physical decay of the asset, but refers instead to the uneconomical use of the asset to you and to the business enterprise which you are conducting. Loss of useful life, and loss of value, may arise also when newly enacted legislation, either directly or indirectly, prohibits the continued use of the property.

It is essential that the property be permanently abandoned to substantiate a deduction for loss of useful value. There can be no deduction if the abandonment is "for the time being." [12] You must show more than a mere cessation of use inasmuch as discontinuance of use is not equivalent to abandonment.[13] When property is continued in use, although not for the purpose for which it was acquired, an abandonment deduction will not be allowed.[14] The possibility that the property may be used in another type of business will not prevent the deduction.[15] However, when the property could be used in another business and has a substantial value, an abandonment deduction may be denied.[16]

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[10] *Ruben H. Donnelly Corp.*, 26 B.T.A. 107 (1932). A taxpayer may not select the year in which he will take a loss on capital assets. The right to take a loss depends upon certain events which the taxpayer must establish in order to justify the deduction.

[11] *Fox River Paper Co.*, 28 B.T.A. 1184 (1933). To the contrary see *California Iron Yards* Co. 15 B.T.A. 25 (1929).

[12] *American Envelope Co.*, 4 B.T.A. 1167 (1926), deduction disallowed for lack of proof of abandonment in the taxable year; *Godson*, T.C. Memo. Op. (1946), par. 46,182 Prentice-Hall Memorandum T.C.

[13] *Williamson Veneer Co.*, 10 B.T.A. 1259 (1928); *I. B. Zumwalt* v. *Commissioner* 25 B.T.A. 566 (1931); *Ewald Iron Co.*, 37 B.T.A. 798 (1938); *The Louisville Fire Brick Works, Inc.*, 43 B.T.A. 178 (1941); *Becker* v. *Anheuser-Busch, Inc.* (8 Cir. 1941), 120 F. (2d) 403, 27 AFTR 433, cert. den. 314 U.S. 625.

[14] *Parkersburg Iron & Steel Co.* v. *Burnet* (CCA 4th 1931), 48 F. (2d) 163, 9 AFTR 1078; *Terre Haute Electric Co.* v. *Commissioner* (7 Cir. 1938), 96 F. (2d) 383, 21 AFTR 118; *C. U. Connellee*, 4 B.T.A. 359 (1926); *J. H. Paget*, 6 B.T.A. 310 (1927); *Morrison, Gross & Co.*, 7 B.T.A. 684 (1927); *Newlyn Coal Co.*, 9 B.T.A. 835 (1928); *Williamson Veneer Co.*, 10 B.T.A. 1249 (1928); *Strong Mfg. Co.*, 11 B.T.A. 944 (1928); *J. Howland Auchincloss, Exec.* 11 B.T.A. 947 (1928); *Covington Cotton Oil Co.*, 12 B.T.A. 1018 (1928); *Moon Journal Publishing Co.* 13 B.T.A. 1379 (1928); *New Jersey Bergen Square Realty Corp.*, 22 B.T.A. 1324 (1931); *Crowninshield Shipbuilding Co.*, 24 B.T.A. 925 (1931); *The Olean-Times-Herald Corp.* 37 B.T.A. 922 (1938).

[15] *Troy Mfg. Co.*, 7 B.T.A. 119 (1927); S.M. 1690, 111-1 C.B. 148.

[16] *W. H. Haskell*, 7 B.T.A. 697 (1927); *Southeastern Building Corp.*, 3 T.C. 381 (1944); *Eastern Building Corp.*, T.C.M. (1944), par. 44,087 Prentice-Hall Memorandum T.C.

A sudden decline in value, although not sufficient to eliminate the entire useful value of the asset, may give rise to a deduction for obsolescence, but will not entitle you to an abandonment loss. You may be able to claim an abandonment loss for the remaining value in a later taxable period, however. The entire loss of useful value to you is not only a prerequisite but also essential in addition to the other factors necessary.

Placing surplus or idle assets in storage for future use is not abandonment, and will not entitle you to a loss deduction.[17] However, when property that has lost its useful value is abandoned, the mere possibility of future use will not prohibit the deduction.[18]

You must not only intend to abandon the property;[19] you must actually discard the property as well.[20] Unless you can prove that the asset was actually abandoned you will not be allowed the loss deduction.[21] Mere declarations of intentions are not sufficient and are ineffective to substantiate an abandonment deduction, inasmuch as the act of abandonment must be consistent with the claim.[22]

Abandonment may be accomplished in various ways. You must not only abandon the asset but you must be able to produce proof of abandonment when requested some time thereafter. The physical act of breaking up machinery or equipment into scrap metal, evidenced by a series of photographs and signed affidavits, should be sufficient proof to convince a tax examiner of the abandonment. Such procedure may seem unnecessary and superfluous at the time, but should constitute conclusive evidence when proof of the abandonment deduction is requested. In addition, inasmuch as there must be an overt act of abandonment[23] within the taxable year, such evidence may prove of great value to substantiate not only the intent but also the act. In connection with the act of abandonment, the asset should be written off the books of account, because the showing of the asset on the company's balance sheet may discredit the loss claim.[24]

When you claim a deduction for worthless securities, you should show that the securities had some value at the beginning of the year and were without value at the close of the year.[25] Proof of value at the commencement of the year may be evidenced by a showing of market value,[26] value which could have been realized upon liquidation or by continuing the business,[27] or by showing that the company had an excess of assets over liabilities.[28] In the few cases where the broker's commission together with the cost of stock transfer stamps would exceed the proceeds from a sale, loss of value probably occurred in a prior year.[29]

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[17] *Flexible File Co.*, 13 B.T.A. 909 (1928), affirmed (6 Cir. 1930) 41 F. (2d) 997; *Ewald Iron Co.*, 37 B.T.A. 798 (1938).

[18] *Wheeling Tile Co.* v. *Commissioner* (4 Cir. 1928), 25 F. (2d) 455, 6 AFTR 7542; *James H. Post*, 12 B.T.A. 510(A) (1928).

[19] *I. G. Zumwalt*, 25 B.T.A. 566 (1932); *Dresser Mfg. Co.*, 40 B.T.A. 341 (1939); *Estate of Charles A. Bickerstaff*, 44 B.T.A. 457 (1941); *Morris Polin*, 39 B.T.A. 951 (1939), reversed on another ground (3 Cir. 1940) 114 F. (2d) 174, 25 AFTR 598.

[20] *White Star Line*, 20 B.T.A. 111 (1930), where title is retained, mere diminution in value does not justify a loss deduction.

[21] *New Jersey Bergen Square Realty Corp.*, 22 B.T.A. 1324 (1931); *Cohen*, T.C. Memo. Op., 1948, par. 48,186 Prentice-Hall Memorandum T.C.; *Bloomington Coca-Cola Bottling Co.*, T.C. Memo., 1950.

[22] *Grass Creek Oil & Gas Co.* v. *Reynolds* (D.C., Wyo. 1933), 71 F. (2d) 1007, 14 AFTR 367.

[23] *Tennessee Consolidated Coal Co.*, 24 B.T.A. 369 (1931).

[24] *Lattimore* v. *U.S.*, 12 F. Supp. 895, 16 AFTR 1240 (Ct. Cls. 1935).

[25] *Merrill*, 31 B.T.A. 530 (1934).

[26] *Livingston*, 46 B.T.A. 538 (1942).

[27] *Franklin Pioneer Corp.* v. *Glenn*, 61 Fed. Supp. 422, 34 AFTR 174.

4. What Type of Assets Can Be Abandoned?

In order for an asset to qualify under the Regulations[30] as one which can be abandoned for tax benefit, it must be

1. a capital asset, as defined by accounting terminology, and not as defined by the Code,[31] and
2. it must be owned by the taxpayer, and
3. it must have been used in his trade or business.

You will note from the above that losses resulting from voluntary demolition and removal of old buildings, scrapping of fixed or capital assets, such as machinery, equipment, furniture, and so forth, are deductible from gross income. Stock in trade in inventory or other property of a kind which is properly includable in inventory, is excluded. Assets owned for personal use and not used in the trade or business of the taxpayer, such as a pleasure automobile or a yacht, do not qualify.

Equipment having a useful life of one year or less, which is charged to expense as purchased, may not be the subject of an abandonment loss.[32]

Some types of business assets which may be the subject of abandonment losses are:

Real estate. Real estate which has become worthless during the taxable year may be abandoned and a loss deduction from gross income obtained, provided the real estate has been used in a trade or business or acquired in a transaction entered into for profit. No loss is allowable for the value of an abandoned personal residence unless the residence had been converted to income producing property prior to the abandonment.[33]

Land. When you conclude that the value of land which you own and use in your business is worthless, refuse to pay taxes thereon, and charge the asset off your books as a loss, you are entitled to an abandonment deduction.[34] The cost of the land and the cost of improvements, if any, cannot be deducted for tax purposes, however, while you continue to retain title thereto.[35] The abandonment must be complete. A gratuitous conveyance of land which is useless to your business will constitute an abandonment for tax purposes.[36] If you abandon improved land, such as a vineyard, an apple orchard, etc., which has suddenly lost its value due to blight, insects, flood, or other causes, you are entitled to claim a deduction from gross income.

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[28] *Eaton* v. *Commissioner* (5 Cir. 1944), 143 F. (2d) 876, 32 AFTR 102.

[29] *Colt*, T.C. Memo. June 8, 1944, par. 44,201 Prentice-Hall Memorandum T.C.

[30] Reg. 118, Sec. 39.23(e)-3. ". . . the usefulness in the business of some or all of the assets is suddenly terminated."

[31] 1954 IRC § 1221; 1939 IRC § 117(a).

[32] *J. E. Mergott Co.* v. *Commissioner*, 176 F. (2d) 860 (3d Cir.) affirms.

[33] *Parker & Delaney*, 186 F. (2d) 455 (1 Cir. 1950), cert. denied, 341 U.S. 926; *Evelyn Weil Barker*, T.C. Memo. 27044; *Leon Chooluck*, T.C. Memo. 1954-1950.

[34] *Rhodes* v. *Commissioner* (6 Cir. 1940) 110 Fed. (2d) 966, 22 AFTR 366.

[35] *A. J. Schwarzler Co.*, 3 B.T.A. 535 (1925): "A taxpayer may not deduct as a loss the cost of real estate and improvements, the title to which it retains." *Consolidated Brick Co.*, 17 B.T.A. 831 (1929); *H. M. N. Muhle*, 19 B.T.A. 1247 (1930).

[36] *Virginia Electric and Power Co.* v. *Early*, 52 F. Supp. 835, 31 AFTR 1186.

Buildings. The abandonment of a building which is worthless to you in your business will entitle you to a deductible loss.[37] The worthlessness may have been occasioned by a change in operations,[38] by the discovery that extensive and costly alterations were required, or by being permanently devoted to a radically different use.[39] When a building is demolished instead of being abandoned, a loss for tax purposes may be claimed.[40] The abandonment of a building under construction also gives rise to an abandonment loss.[41]

Architects' fees. When architects' plans for a proposed business building have been prepared and the proposed project is abandoned, a loss arises in the year of abandonment, provided the taxpayer is reporting on the accrual basis.[42] The amounts expended for architects' services represented an investment in the business enterprise, and were lost when the plans for the new building were abandoned. The abandonment must be final and not just for the time being, however.[43] Cost and ownership must be substantiated in order to warrant the deduction.[44]

Machinery. Machinery which has become worthless suddenly may be abandoned in the year it loses its value, and the depreciated cost less salvage value, if any, may be claimed as a loss[45] if the machinery is permanently abandoned. Newly purchased machinery may be abandoned and a deduction claimed where the decision to abandon is made after the machinery arrives at the company's plant.[46] Every effort should be made, however, to dismantle the machine and sell the individual parts. Failure to salvage the machine or to ascertain its salvage value will prohibit the claim for an abandonment loss.[47]

Equipment. The depreciated cost of equipment may be claimed as a loss deduction whether the equipment is abandoned or scrapped. When the equipment can no longer be used in the business without jeopardizing future profits, a loss of economic usefulness results. Such loss, based upon the adjusted basis, is deductible.[48] When you have manufactured business equipment with your own material and labor, an abandonment deduction is permissible provided the cost of construction was capitalized on your books and not charged to operating expense.[49]

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[37] *Kilby Car & Foundry Co.*, 4 B.T.A. 1294 (1926) (building was constructed for a particular purpose and abandoned); *Fraser Brick Co.*, 10 B.T.A. 1252 (1928).

[38] *American Cigar Co.*, 21 B.T.A. 464 (1931).

[39] *Multibestos Co.*, 6 B.T.A. 1060 (1927) (building abandoned because of a change in business conditions).

[40] *Kaye et al.*, 7 B.T.A. 678 (1927) (held: no loss could have occurred until the buildings were demolished); *Paget*, 6 B.T.A. 310 (1927); *Wisconsin National Bank*, 4 B.T.A. 109 (1926).

[41] *Connellee*, 4 B.T.A. 359 (1926). A hotel venture was abandoned and the enterprise terminated; taxpayer was allowed deduction for amounts invested.

[42] *Buedingen*, 6 B.T.A. 335 (1927) (Acq.); *Continental Trust Co., Fourth National Bank*, 7 B.T.A. 539 (1927); *Murphy Transfer & Storage Co.*, 7 B.T.A. 1148 (1927) (Acq.) (Plans were not paid for until year following abandonment); *Western Wheeled Scraper Co.*, 14 B.T.A. 496 (1928) (Acq.); *Tom (Fayette T.) Moore*, 19 B.T.A. 140 (1930) (Acq.).

[43] *American Envelope Co.*, 4 B.T.A. 1167 (1926); *Godson*, T.C. Memo. Op. (1946), par. 46,182 Prentice-Hall Memorandum T.C.

[44] *Baylor*, T.C. Memo. Op. (1943), par. 43,490 Prentice-Hall Memorandum T.C.

[45] *Dilling Cotton Mills*, 2 B.T.A. 127 (1925) (taxpayer discarded machinery and equipment owing to change in business conditions); *Green Oil Soap Co.*, 3 B.T.A. 467 (1925); *King Lumber & Oil Co.*, 4 B.T.A. 1253 (1926); *Monroe Cotton Mills*, 6 B.T.A. 172 (1927); *Safe Guard Check Writer Corp.*, 10 B.T.A. 1262 (1928); *Shiner Oil Mill & Mfg. Co.*, 11 B.T.A. 805 (1928): Where taxpayer purchased mote boards for a specific purpose and in the same year discarded them as they were of no further use to the taxpayer, the total cost was deductible as a loss inasmuch as the boards had no salvage value.

[46] *Manischewitz Co.*, 10 T.C. 1139 (1948).

[47] *Ticket Office Equipment Co., Inc.* 20 T.C. 32.

Furniture and fixtures. A loss, representing the undepreciated cost less salvage value, is allowable when furniture and fixtures are abandoned.[50]

Dies. The undepreciated cost of worthless dies may be deducted when the use of the dies is discontinued and the dies abandoned.[51]

Engines and boilers. You may deduct from gross income the aggregate capital expenditures made in connection with development and experimental work on an engine, which proved to be a failure, and all efforts to perfect the engine are abandoned.[52] When old boilers are discarded and replaced by new boilers, the undepreciated cost of the old boilers, less the value of salvage, may be claimed as a loss in the year in which the replacement is made.[53]

Electrical equipment. Loss on abandonment of electrical equipment or devices which are found to be inadequate is deductible provided the equipment or devices are used in a trade or business. When the asset is used for pleasure and not for business, the loss sustained from abandonment is not deductible.[54] The value of electrical wiring and fixtures, discarded when you move your business from an established location to a new location, is allowable as a loss from abandonment.[55]

Experimental costs. Development or experimental costs, which have not been charged to expense and deducted otherwise, may be deducted from gross income when the project or experiment is stopped and the undertaking abandoned.[56]

Motor busses. The sale of motor busses for salvage values establishes an abandonment deduction when the busses are sold, provided they have been in use, although only for emergencies, to the year of sale.[57] There must, however, be an undepreciated value. If the busses are fully depreciated there will be taxable income instead of a deductible loss.

Patents. Amounts expended toward the development of a patent, the unamortized cost of a patent, and expenditures made in constructing products under a patent, may be deducted as losses provided the invention or patent is in fact worthless and is abandoned.[58] Worthlessness must occur in the same year in which there is an identifiable act of abandonment. A mere mental attitude, however, is insufficient to prove intent to abandon.[59] Where the value of the patent is diminished only, and not exhausted, no loss is deductible.[60]

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[48] Mim. 5870; 1945 C.B. 91.

[49] *J. E. Mergott Co.*, 11 T.C. 47 (1948), affirmed (3 Cir. 1949) 176 F. 2d 860.

[50] A.R.R. 469, 4 C.B. 164; *I. Frank Sons Co., Inc.*, 22 B.T.A. 40 (1931).

[51] *Gouri Drawn Metals Co.*, 8 B.T.A. 853 (1927): Taxpayer carried dies on its books at cost. Depreciation had never been taken. Loss was allowed for the unextinguished useful value of the dies representing the allowable depreciation plus salvage value deducted from cost.

[52] *Dresser Manufacturing Company*, 40 B.T.A. 341 (1939).

[53] O.D. 871; 4 C.B. 179; *Walcott Lathe Co.*, 2 B.T.A. 1231 (1925); *Henry M. Jones*, 4 B.T.A. 1286 (1926).

[54] *J. Weingarten, Inc.*, 44 B.T.A. 798 (1941); *Shea et al.*, 24 B.T.A. 798 (1931).

[55] *Kay Mfg. Co.*, 18 B.T.A. 753 (1930), affirmed (2 Cir 1932) 53 F. 2d 1083, 10 AFTR 763.

[56] *Flannery*, T.C. Memo. Op. (1946), par 46,103 Prentice-Hall Memorandum T.C.; *Acme Products Co., Inc.*, 24 B.T.A. 194 (1931); *Portland General Electric Co.*, T.C. Memo. Op. (1947), par. 47,299 Prentice-Hall Memorandum T.C.

[57] *Omnibus Corp., et al.* v. *U.S.* (4 Cir. 1942), 29 AFTR 1486: Busses had been stored for three years prior to the year of sale.

Trade marks. An investment by you in trade marks and trade names which becomes valueless may be deducted in the year you sustain the loss.[61] A temporary condition limiting the use of trade marks or trade names will not be sufficient to substantiate a deduction.[62]

Formulae. You may deduct the amount of your loss, which results from the sudden worthlessness of a formulae used in your trade or business to the extent of your investment, from gross income.[63]

Leases. When there is no obligation imposed on a lessee to maintain and return premises to the lessor in the same condition as at the beginning of the lease, the lessor is entitled to a loss deduction on the cancellation and abandonment of the lease, provided there is no property in existence to be returned to the lessor.[64] If such an obligation is imposed on the lessee, a deduction by the lessor will be denied.[65] When a portion of the premises are abandoned during the term of a lease, and the rent is not reduced accordingly, the lessor will not be entitled to an abandonment deduction at the expiration of the lease.[66] Should a lessee, at the expiration of a lease, return the premises in as good condition as at the beginning, the lessor is not entitled to an abandonment deduction unless he abandons the premises.[67] Upon the abandonment or forfeiture of a worthless lease by a lessee prior to the expiration of its term, any unamortized capital expenditures made by the lessee, such as leasehold improvements, entitle the lessee to an abandonment deduction in the year of forfeiture for the amount of his loss.[68] A lessee must relinquish all his right, title, and interest in a lease or it must have expired or been cancelled by him.[69] A defective title will justify an abandonment.[70]

Organization expenses. Amounts paid for acquiring a charter and for organization expenses at the time of incorporating a company may, at the election of the corporation, be treated

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[58] *Rae Estate* v. *Commissioner* (3 Cir. 1945), 147 F. 2d 204, 33 AFTR 648; *Canning*, 29 B.T A. 99 (1933); *Liberty Baking Co.* v. *Heiner* (3 Cir. 1930), 37 F. 2d 703, 8 AFTR 10011; *Connecticut National Pavements, Inc.*, 3 B.T.A. 1124 (1926); *O'Neill Machine Co.*, 9 B.T.A. 567 (1927); *Tennessee Fibre Co.*, 15 B.T.A. 133 (1929).

[59] *William Bentley* v. *Commissioner*, T.C. Memo. No. 32170.

[60] *Consolidated Window Glass Co.*, 1 B.T.A. 365 (1924).

[61] *Sheffield Dentifrice Co.*, 13 B.T.A. 877 (1928); A.R.R. 185, 3 C.B. 156.

[62] *Charles M. Monroe Stationery Co.*, 3 B.T.A. 69 (1925).

[63] *National Chemical Mfg. Co.* v. *U.S.*, 607 Ct. Cls. 607 (1929), 71 AFTR 9109; *J. Weingarten, Inc.*, 44 B.T.A. 798 (1941).

[64] *Terre Haute Electric Co.* v. *Commissioner* (7 Cir. 1938), 96 F. (2d) 383, 21 AFTR 118.

[65] *Portland Railroad Co.*, T.C. Memo. Op. (1944), par. 44,085 Prentice-Hall Memorandum T.C.

[66] *Beech Creek R.R. Co.*, 5 T.C. 135 (1945).

[67] *Delmonte Investment Co.*, B.T.A. Memo. Op., 1932.

[68] *Bowen*, 2 B.T.A. 1043 (1925) (Acq.); *Huey*, 4 B.T.A. 370 (1926) (Acq.); *Adams, B. G.*, 5 B.T.A. 113 (1926) (Acq.); *Greever, et al.*, 6 B.T.A. 587 (1927) (Acq.); *Fell*, 7 B.T.A. 263 (1927) (Acq.); *Belridge Oil Co.*, 11 B.T.A. 127 (1928) (Acq.); *McCallum*, 14 B.T.A. 805 (1929) (Acq.); *Reese Drilling Co.*, 18 B.T.A. 816 (1930) (Acq.); *Colorado & Utah Coal Co.*, 26 B.T.A. 588 (1932) (Acq.); *Simms Petroleum Co.*, 28 B.T.A. 1107 (1933) (Acq.); *Colton* v. *Helvering*, 68 F. (2d) 436 (D.C. Cir. 1933).

[69] I.T. 2289, V-1 C.B. 241; S.M. 5700, V-1 C.B. 241.

[70] *Morefield et ux.*, 4 B.T.A. 394 (1926) (Acq.).

1. as capital expenditures, or
2. as deferred expenses.

When the corporation elects to treat the organization expenses as capital expenditures, an abandonment loss may be claimed in the year the corporation is dissolved and its corporate franchise abandoned.

When the corporation elects to treat the organization expenses as deferred expenses, however, the expenditures may be deducted ratably over such period as the corporation desires, but not less than sixty months, beginning with the month in which the corporation begins business.[71]

Securities. Securities, including stocks, bonds, debentures, notes, and certificates, which become worthless during the taxable year, may be the subject matter for an abandonment deduction.[72] When all possibility of salvaging something on the security is gone and no liquidating value remains, the loss has been sustained.[73] When any potential value remains, even of a prospective nature, the security is not worthless.[74] As with other assets, a mere decline in value does not entitle the owner to a deductible loss.

5. When Should the Asset Be Abandoned?

Administrative regulations and court decisions indicate that you must prove beyond doubt that you have sustained a loss and that the act of abandonment was in the taxable year in which the deduction was claimed. The deduction should be taken in the year in which the asset is actually abandoned and the asset is retired on your books.[76] However, the loss of useful value to the business and the act of abandonment need not occur simultaneously.

When you discover that you have a worthless asset, you will, generally, be allowed time and opportunity to

1. convert the worthless item into an item of value, or
2. determine the salvage value

before claiming an abandonment deduction. If you are able to prove that the asset was worthless when it was abandoned you will, generally, be allowed the deduction even though the item became worthless in a prior year.[77] When the lapse of time between the year of worthlessness and the act of abandonment is unreasonable, the loss deduction may be disallowed.[78]

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[71] *Malta Temple Association,* 16 B.T.A. 409 (1929); *Pacific Coast Biscuit Co.,* 32 B.T.A. 39 (1935); *The Liquidating Co.,* 33 B.T.A. 1173 (1936); 1954 IRC § 248.

[72] *Royal Packing Co.* v. *Commissioner* (9 Cir. 1928), 22 F. (2d) 536, 6 AFTR 7059.

[73] *Sterling Morton* v. *Commissioner* 112 F. (2d) 320.

[74] *Clark* v. *Welch* (1 Cir. 1944), 140 F. (2d) 271, 32 AFTR 33.

[75] Robert C. Browne, "The Time for Taking Deductions for Losses and Bad Debts for Income Tax Purposes," *University of Pennsylvania Law Review,* 1935, Vol. 84, pages 41-45.

[76] *Boston and Maine R.R.,* 16 T.C. 1517.

[77] *Flexible File Co.,* 13 B.T.A. 909 (1928).

[78] *Superior Coal Co.,* T.C. Memo. 1943, par. 43,482 Prentice-Hall Memorandum T.C. affirmed (7 Cir. 1944) 33 AFTR 83.

The determination of whether the lapse of time is unreasonable or not will be governed by the circumstances and the type of asset involved. You should not defer the abandonment of an asset deliberately after it is known to be worthless. To allow otherwise would enable you to claim an abandonment deduction in the year most advantageous to you tax-wise.

When you own securities which have become worthless, you should claim an abandonment deduction in the year in which the loss occurred.[79] Losses from worthless securities are deductible only in the taxable year in which the securities became valueless. The worthlessness of securities usually arises from the happening of some "identifiable event," such as bankruptcy, receivership, or dissolution. When you cannot discover the "identifiable event," the loss should be claimed in the year when the securities actually became worthless.[80] Inability to discover both the "identifiable event," and the year of worthlessness should not prohibit the loss deduction. Board cases have allowed deductions in the year in which the loss was claimed even though worthlessness occurred in a prior year.[81] Failure to claim a deduction as soon as the facts warrant, however, may deprive you of the loss forever. (Consideration should be given to further comments on worthless securities in Sections 4, 6, and 7 of this chapter.)

Recent decisions indicate that the act of abandonment is, to a considerable extent, in the control and discretion of the taxpayer. You may, within reason, designate the year in which you wish to abandon a worthless asset, especially where there is a dispute and pending litigation.[82] When you raise a dispute which is subsequently settled unfavorably to you, the year in which the dispute is settled governs the year of loss. This is so even though it later develops that there was no legal basis for the dispute, provided you conscientiously believed that you had a bona fide dispute.

You should not claim an abandonment loss where the depreciation deduction for the asset abandoned has been based on the composite life of a group of assets, of which this asset was a part, rather than on the actual useful life of the asset abandoned. Such assets, when normally retired, must be charged to the depreciation reserve. The loss on an early retirement, if any, will be recouped through annual depreciation taken on the discarded asset after the premature retirement. The use of an average, or composite, rate of depreciation, contemplates normal retirements both before and after the average life expectancy which has been adopted. When the final asset in the group is retired, the remaining balance may be claimed as a loss deduction.

When you can show that the worthlessness of an asset arose from abnormal and unanticipated causes, and that the early retirement was not contemplated when the composite rate of depreciation was chosen, a deduction will be allowed for the difference between the net depreciated value and any salvage value.[83] Such abnormal losses are separate and apart from possible recoveries through depreciation.[84] You may apply the same rule also where the depreciation rate has been based upon the expected life of the longest lived asset in the group. Losses of this nature are not compensated for by depreciation.

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[79] *Harry H. DeLoss* v. *Commissioner* (2 Cir. 1928), 28 F. (2d) 803, 7 AFTR 8228; *Capital Service, Inc.*, T.C. Memo., May 10, 1949, par. 49,112 Prentice-Hall Memorandum T.C.

[80] *Royal Packing Co.* v. *Commisioner* (9 Cir. 1928), 22 F. (2d) 536, 6 AFTR 7059.

[81] *Thompson*, B.T.A. Memorandum Op., Oct. 15, 1941, par. 41,457 Prentice-Hall Memorandum B.T.A.; *Konta*, B.T.A. Memorandum Op., April 9, 1942, par. 42,212 Prentice-Hall Memorandum B.T.A.

[82] *Edwards & John Burke, Ltd.*, 3 T.C. 1031 (1944): Taxpayer attempted unsuccessfully for three years (1937-1940) to redeem real estate sold in 1935 for unpaid 1934 taxes. Abandonment loss allowed in 1940.

Should you discover that you have valueless (to you) real property which you wish to abandon, you should learn and be acquainted with the following rules:

1. The property must be valueless, or have a value no greater than unpaid tax liens.
2. You must have an intent to abandon the property within the taxable year it becomes valueless.
3. There must be some overt or specific act to carry out the intention to abandon.

You will note that if you own real estate and the value of the property has been completely extinguished within the taxable year, it is possible for you to obtain an abandonment deduction. You should claim the loss in the year in which the value of the real estate becomes extinct; otherwise you may lose the deduction forever.[85] One Court, at least, held that although a deduction may be established by an abandonment, the specific act of abandonment must occur in the same year in which the property became valueless.[86]

Although local laws may not recognize the abandonment of the title to the real estate, you are still entitled to the deduction for federal tax purposes, provided you comply with the requirements.[87] When you refuse to pay local taxes, abandon the real estate, and charge off the resulting loss on your books, you will be entitled to the loss deduction.[88] A quit claim deed of the real estate, in favor of the local tax collector without consideration or by reciting one dollar consideration, has been held to be sufficient evidence of an intent to abandon the property even though the deed did not pass title under the local laws.[89]

The abandonment of worthless real estate, coupled with a sale of the property by local authorities for unpaid taxes, also gives rise to a deduction in the taxable year.[90]

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[83] *U.S. Industrial Alcohol Co.*, 42 B.T.A. 1323 (1940), affirmed and reversed in part (2 Cir. 1943), 137 F. (2d) 511, 31 AFTR 425.

[84] *Southland Coal Co.*, 16 B.T.A. 50 (1929).

[85] *DeLoss* v. *Commissioner* (2 Cir. 1928), 28 F. (2d) 803, 7 AFTR 8228, cert. den. 279 U.S. 840.

[86] *Commissioner* v. *McCarthy* (7 Cir. 1943), 139 F. (2d) 20, 31 AFTR 975, reversing 44 B.T.A. 417 (1941). The Court held that there must be "a complete elimination of all value, and the recognition by the owner that his property no longer has any utility or worth to him."

[87] *Denman* v. *Brumback* (6 Cir. 1932), 58 F. (2d) 128, 11 AFTR 156; *Schwarzler Co.*, 3 B.T.A. 535 (1925). Early cases indicate there could be no abandonment loss when the taxpayer retains title. *Greenleaf Textile Corp.*, 26 B.T.A. 737 (1932), affirmed (2 Cir. 1933) 65 F. (2d) 1017, 12 AFTR 916 (loss was not allowed where title was retained despite decrease in value); *T. J. Bosquett*, 39 B.T.A. 763 (1939).

[88] *Bulkley Building Co.*, T.C. Memo. Op. (1943), par. 43,068 Prentice-Hall Memorandum T.C.

[89] *Bickerstaff* v. *Commissioner* (5 Cir. 1942), 128 F. (2d) 366, 29 AFTR 508, reversing 44 B.T.A. 457 (1941); cf. *C. Ledyard Blair*, T.C. Memo. (1946), par. 46,206 Prentice-Hall Memorandum T.C., Dock. 6304, C.C.H. Dec. 15,354; *Jamison*, 8 T.C. 173 (1947) (A). (A voluntary conveyance to a municipality after failure to pay taxes constituted an abandonment of the property.)

[90] *Rhodes* v. *Commissioner* (6 Cir. 1939), 100 F. (2d) 966, 22 AFTR 366, reversing 34 B.T.A. 212 (1936) (loss allowed although taxpayer did not divest himself of legal title);

A loss resulting from a sale of real estate for unpaid taxes is considered a capital loss and not an ordinary one, where there is no act of abandonment.[91] Where the property is abandoned before the tax sale takes place, however, the loss is an ordinary one and is deductible in full. A tax sale of real estate alone is not sufficient to substantiate a loss, provided local laws allow a statutory period of redemption within which the property may be redeemed. Until the redemption period has expired, there is no abandonment of your equity in the real estate. An expressed intention not to redeem the property will not negate this rule. Submission of proof that the value of the abandoned real estate is less than unpaid tax liens, coupled with a tax sale, will satisfy the requirements.

When you are liable on a mortgage note and your equity in the real estate has diminished to the amount of the mortgage debt, there is no need to deed or quitclaim title to the real estate to the mortgagee. If the mortgagee will accept the real estate in satisfaction of your debt, a loss will be recognized for tax purposes.[92] In such a situation, however, the time of your loss is fixed at the time of the conveyance and the amount of your loss is the amount of your equity in the real estate. The conveyance of the real estate to the mortgagee must, nevertheless, be sufficient to pass full title.[93]

The acceptance of the deed by the mortgagee must be in complete satisfaction of the mortgage debt so as to extinguish completely the mortgagor's liability. If there is any possibility of the mortgagee obtaining a deficiency judgment against you on the debt, the abandonment loss must await a sale by foreclosure.[94]

When the mortgagee refuses to accept a deed to the real estate prior to a foreclosure sale, the abandonment loss may be obtained provided you, as the mortgagor, refuse to pay taxes or mortgage interest, and allow a receiver to be appointed for the real estate.[95] However, it is necessary to prove that the equity has become valueless; otherwise the loss for the abandonment will be postponed until the amount of the loss can be determined at a foreclosure sale.[96]

Any subsequent act by you as mortgagor, such as paying mortgage interest and real estate taxes, especially after you have offered to extinguish your debt by giving a deed to the mortgagee, will contradict and defeat your claim of abandonment.[97]

Should you demolish or raze an old building you are entitled to an abandonment loss in the year demolition actually occurs.[98] When you purchase land and buildings and the buildings are immediately demolished with the intention of erecting a new building, you will not be entitled to an abandonment deduction for the razing of the old building, and not allowed a deduction for the cost of remov-

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Chaparral Oil Co. 43 B.T.A. 457 (1941); *Helvering* v. *Gordon* (4 Cir. 1943), 134 F. (2d) 685, 30 AFTR 1178; *Jamison* v. *Commissioner* 8 T.C. 173 (1947).

[91] *Helvering* v. *Nebraska Bridge Supply and Lumber Co.* 313 U.S. 598 (1941).

[92] *Morris Polin,* 39 B.T.A. 951 (1939); *Philip S. Parker* v. *Delaney,* D.C. Mass. (1950) affirmed (1 Cir. 1951) 186 F. (2d) 455; *Woodsam Associates, Inc.,* 16 T.C. No. 80.

[93] *Commonwealth, Inc.,* 36 B.T.A. 850 (1937).

[94] *Commissioner* v. *Green* (3 Cir. 1942), 126 F. (2d) 70, 28 AFTR 1286.

[95] *W. W. Hoffman,* 40 B.T.A. 459 (1939), affirmed (2 Cir. 1941) 117 F. (2d) 987, 26 AFTR 486.

[96] *Commissioner* v. *Abramson* (2 Cir. 1942), 124 F. (2d) 416, 28 AFTR 779.

[97] *Harriss* v. *Commissioner* (2 Cir. 1944) 143 F. (2d) 279, 32 AFTR 958.

[98] *Wisconsin National Bank,* 4 B.T.A. 109 (1926); *Pagent,* 6 B.T.A. 310 (1927) (Acq.); *Kaye et al.,* 7 B.T.A 678 (1928).

ing the demolished structure from the land.[99] The adjusted value of the land will consist of the original cost of the land and buildings to which should be added the cost of removing the unwanted and demolished building or buildings. If you can prove that, at the time of purchasing the real estate, you fully intended to use the building for a specific purpose and had no intention of demolishing it, the razing of the building, even though done immediately after the purchase, will entitle you to an abandonment loss in the year of razing.[100] When the principal reason for demolishing the building is to increase the value of adjoining property, there is no allowable loss.[101] But note that when the removal of the building does not increase the value of the land, or of the adjoining property, the loss may be deducted.[102] When the sole purpose of purchasing a plant is to remove an existing business from competition, although immediately after the purchase it is decided to demolish the buildings, an abandonment deduction occurs in the year the plant is demolished.[103]

If your building is demolished by a lessee and an uncompleted new building reverts to you as the lessor, you are entitled to an abandonment loss for tax purposes.[104]

6. How Is the Amount of the Abandonment Loss Computed?

When you have business assets, of whatever character, which you intend to abandon because they have lost their useful value to you, and you have complied with the other requirements outlined in this chapter, a loss deduction can be taken for tax purposes.

The computation of the amount of the loss deduction, however, may prove troublesome. Three factors must be known: two of these are easily ascertained, but the third factor may be difficult to determine.

You probably know	*You may not know*
The cost of the asset to be abandoned.	The amount of the scrap or salvage value of the asset to be abandoned.
The amount of depreciation allowed or allowable for tax purposes.	

Once you have determined the three factors outlined above, the difference between the depreciated cost of the asset and the salvage value may be deducted as a loss. For example, let us assume that you purchased a machine for $5,000. Freight, trucking, and installation cost $800, and subsequent additions cost $500. Depreciation of $1,575 has been claimed for tax purposes. The estimated scrap value is $400. You are entitled to an abandonment deduction of $4,325 for tax purposes computed as follows:[105]

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[99] *Columbus Brick & Tile Company*, 26 B.T.A. 794 (1932); *Liberty Baking Co.* v. *Heiner* (3 Cir. 1930), 37 F. 2d 703, 8 AFTR 10011; *Union Bed & Spring Co.* v. *Commissioner* (7 Cir. 1930), 39 F. (2d) 383, 8 AFTR 10516; *Milwaukee Woven Wire Works*, 16 B.T.A. 75 (1929).

[100] *Meyer Levy* v. *Commissioner*, 10 B.T.A. 907 (1928).

[101] *Ingle* v. *Gage* (Dist. Ct. 1931), 52 F. (2d) 738, 10 AFTR 480.

[102] Footnote 22 above.

[103] *Sanitary Co. of America* v. *Commissioner* (3 Cir. 1929), 34 F. (2d) 439, 7 AFTR 9360.

[104] *Eysenbach*, 10 B.T.A. 716 (1928) (Acq.).

[105] *Dilling Cotton Mills*, 2 B.T.A. 127 (1925); *Safe Guard Check Writer Corp.*, 10 B.T.A. 1262 (1928) (Acq.); *Shiner Oil Mill & Mfg. Co.*, 11 B.T.A. 805 (1928) (Acq.).

Cost of machine	$5,000
Freight, trucking and installation	800
Additions	500
Total investment	$6,300
Less: Depreciation taken	1,575
Net depreciated value	$4,725
Less: Scrap value	400
Abandonment deduction	$4,325

It is essential that you determine and show the salvage value of the asset inasmuch as failure to consider salvage value may result in the disallowance of the deduction.[106]

A sale of the discarded asset as scrap following abandonment conclusively establishes the scrap or salvage value.[107] Expenses of the sale, such as auctioneering fees, advertising expense, freight, express, or trucking, should be used to reduce the proceeds of the sale, thereby increasing the amount of the abandonment deduction.

When you have made unsuccessful attempts to sell the abandoned asset, such efforts will constitute proof of the absence of a salvage value.[108] Inasmuch as the expression "salvage value" implies market value, the failure to effectuate a sale indicates the lack of market value. The amount of the deduction is the net depreciated value without deduction for salvage value.[109]

You may find that the amount of the salvage value is less than the cost of demolishing the asset and the expense of making the sale. If so, the net depreciated value of the asset should be increased by the excess cost and the total unextinguished loss deducted.[110] When the amount of the salvage value exceeds the net depreciated value of the asset, you will not have a loss deduction and you may have taxable gain.[111]

The cost basis of the asset to be abandoned must be reduced by prior depreciation or by prior amortization.[112] Correct determination of the amount to be used for this purpose may present a perplexing problem. The correct amount may not be the aggregate of the annual deductions for depreciation which have been taken, but may be instead the total of the deductions which were allowable and should have been taken.[113] If you have not taken aggregate amount of depreciation allowable under the tax law, you may have lost the depreciation deduction forever.

When the asset to be abandoned is one of a group and has been depreciated in prior years by using a composite rate applicable to all the assets in the group, the cost basis of the particular asset to be abandoned must be reduced by straight-line depreciation.[114] The composite rate which has been used may not be used in depreciating an asset which has been withdrawn from a group before it has lived its anticipated life. The depreciation which was taken on the particular asset is not the amount "allowable." This is so because the composite rate used was developed for all assets in the group, and the asset withdrawn now ceases to be one of the group.

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[106] *Harris Bros. Dairy Co.*, 10 B.T.A. 293 (1928).

[107] ARR 93, 2 C.B. 142.

[108] *Levine Bros., Inc.*, 5 B.T.A. 689 (1927).

[109] *George Leavenworth*, 1 B.T.A. 754 (1925).

[110] *Rising Sun Brewing Co.*, 22 B.T.A. 826 (1931); ARR 6349, 111-1 C.B. 148.

[111] S.M. 1217, 1 C.B. 120.

[112] I.T. 3652; 1944 C.B. 118.

[113] *United States* v. *Ludey*, 274 U.S. 295, 6 AFTR 6754 (1927); *Kittredge* v. *Commissioner* (2 Cir. 1937), 88 F. (2d) 632, 19 AFTR 177.

[114] *U.S. Industrial Alcohol Co.*, 42 B.T.A. 1323 (1940); *Mason City Brick & Tile Co.* v. *Huston*, 36 F. Supp. 515, 26 AFTR 510; *Evans-Winter-Hebb, Inc.*, par. 42,423 Prentice-Hall Memorandum B.T.A.

When the asset being abandoned has been fully depreciated or amortized there is no "use" or "useful life" remaining and no deduction is obtainable.[115] The permission to deduct an abandonment loss, as provided by regulations, is intended to apply only when you deem it unwise to continue using the asset.

7. Should You Sell or Abandon the Asset?

The abandonment or demolition of an asset usually gives rise to an ordinary loss deductible in full for tax purposes provided the rules outlined in this chapter have been complied with. Losses on sales or exchanges of capital assets, excluding depreciable business property, however, may be subject to the capital loss limitations.[116]

You should know that the requirements for abandonment—namely, intent coupled with the act of abandonment—must be complied with and you must also realize that you may have the additional burden of convincing a revenue agent that you are entitled to the loss. Under certain circumstances and conditions, this latter requirement may prove difficult.

You should have in mind the definition of a capital asset as interpreted for tax purposes.[117] Under the present Code definition, assets used for business purposes and subject to depreciation, such as buildings, machinery, and equipment, are excluded as capital assets except as interpreted for the privilege of the alternative tax computation.[118] Land is excluded,[119] as is merchandise. The limitations provided in the law with respect to sales of capital assets subject to depreciation, therefore, have no application to losses resulting from abandonment.

In order to qualify for an ordinary loss deduction, the property must be abandoned and retired from use due to loss of useful value. The property, thereafter classified as salvage, ceases to be used in the trade or business and is not "of a character which is subject to the allowance for depreciation." Sales of abandoned property represent incidental recoveries only, and serve as an adjustment of the loss sustained at the time of abandonment. Book entries, however, should indicate that the property had been discarded and that the property actually had been sold for salvage.[120]

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[115] *Frank Butcher*, T.C. Memo. Op., June 22, 1949, par. 49,167 Prentice-Hall Memorandum T.C.

[116] 1954 IRC § 1211; 1939 IRC § 117.

[117] 1954 IRC § 1221 reads in part as follows: "The term capital assets . . . does not include . . . property . . . of a character which is subject to the allowance for depreciation . . ."

[118] 1954 IRC § 1201(a) and (b); 1939 IRC § 117(c)(1) and (2).

[119] The Revenue Act of 1942 amended Section 117 of the 1939 Internal Revenue Code so as to exclude land used in a trade or business from the definition of capital assets. The 1954 Code, Section 1221 does not change this rule.

See *Three States Lumber Co.* v. *Commissioner* (7 Cir. 1947), 158 F. 2d 61, 35 AFTR 357 and *Fahs* v. *Crawford* (5 Cir. 1947), 161 F. 2d 315, 35 AFTR 1228. Also, *Carter-Colton Cigar Co.*, 9 T.C. 219 (1947) where Sec. 117(j) was held to apply to unimproved property.

The present definition of capital assets eliminates, to a great extent, the problem of deciding whether you should claim an abandonment deduction or consumate a loss sale. With the exception of capital assets not of a depreciable character, such as securities, the loss for tax purposes is the same whether you elect to abandon an asset or to sell the asset for junk or salvage value.

The principal advantage to be gained from selling an asset, and claiming the resulting loss, is the avoidance of a possible controversy with an examining agent regarding proof in substantiation of the elements of abandonment. A sale of an asset, with a resulting loss, generally establishes the year of the loss provided the sale is an arm's length transaction. An abandonment, however, may require proof that the loss did not occur in a prior year.

A loss arising from an abandonment or sale of a capital asset, such as stock issued by a corporation, may or may not be deductible for tax purposes, depending upon various circumstances. You should have in mind, therefore, the rules regarding losses from worthlessness of securities and losses arising from a sale or exchange.[121]

When stock which is a capital asset becomes worthless, the loss sustained is considered as having arisen from a sale or exchange on the last day of the taxable year. The holding period, which determines whether the loss is short term or long term, ends with the last day of the year in which the stock becomes worthless.

As losses arising from worthless stocks are subject to the capital loss limitations and may not be deductible in full, you may avoid the necessity of proving worthlessness by selling the stock before the time worthlessness occurs. Furthermore, losses from partially worthless stock cannot be deducted, except by dealers in securities. But losses arising from sales of stock may be used to offset capital gains or, if sustained by an individual, may be used, with limitations, to offset other income. Thus, you are able to obtain a loss deduction in advance of the year of complete worthlessness.

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[120] *Industrial Cotton Mills Co.,* 43 B.T.A. 107.

[121] 1954 IRC § 165(g). If any securities (as defined in paragraph (2) of this subsection) become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, for the purposes of this chapter, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

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35

The Net Operating Loss Deduction

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Profit is the basic motive for starting and continuing any trade or business. Because American businessmen have had a remarkable degree of success in operating their businesses, our industrial and economic wealth has increased by leaps and bounds. Within the past thirty years, the number of concerns increased from 1,700,000 to almost 2,500,000.

In spite of this phenomenal record, a closer examination of our free competitive system shows that not all businesses always succeed in making profits.[1] Some businesses operate "in the red" one year and "in the black" the next.

Our government has always tried to keep itself and business advised so that both may advance steadily, and our fiscal and tax policies clearly reflect this purpose. The net operating loss deduction provisions[2] serve as an excellent example. They have been instrumental in keeping many businesses going—in giving them an opportunity to continue to make a profit.

1. Points to Consider

Section
Purpose of the net operating loss deduction provisions 2
Significance of net operating loss adjustments 3
Technical aspects of the net operating loss deduction 4
The effect of liquidation on the loss offset provisions 5
Procedure and practice problems 6

2. Purpose of the Net Operating Loss Deduction Provisions

a. Encourage new businesses. Business has greatly benefited from the existence of the net operating loss deduction provisions in our tax structure. Basically, our system of doing business advocates and encourages new ventures. New concerns create new products, employment, and the possibility of reduced prices on competitive products. But new ventures are generally very unstable, especially during the initial years of their existence. The possibility of incurring operating losses in introducing new products or competing against established firms is very great. To overcome this disadvantage and make investments in new concerns less precarious, the net operating loss provisions permit such losses to be offset against prior and future taxable income. In effect, they provide a means of "averaging"[3] income over a period of years.

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[1] A survey of 4,381 business failures in 1948 among retail, wholesale, and manufacturing concerns indicates that 69 per cent of the failures were of concerns established since 1945; 28.1 since 1947. Dun & Bradstreet, Business Information Division, April, 1949.

[2] Sec. 172 of the Revenue Act of 1954; Sec. 122 (added by Sec. 211 of the Revenue Act of 1939), as amended by Secs. 105, 150, and 153 of the Revenue Act of 1942 and Sec. 215(a) of the Revenue Act of 1950.

b. Share losses. It is commonly said that the Government is a partner in the affairs of business. This is certainly true when the business earns a profit; to a much more limited extent, it shares losses too. The possibility of recouping part of such losses from the Government by way of the carry-back and carry-forward offsets will in many cases enable faltering companies to continue in operation. In addition, these offsets contribute to cyclical stability. Business expenditures do not have to be so severely restricted in loss years, because business managers are less fearful of making expenditures if they know that such costs may be offset against taxable income of prior and future years.

c. To provide a reserve for reconversion losses. During the war, considerable pressure was exerted by business to permit the deduction of reconversion reserves. Businessmen felt that wartime income could not be correctly determined unless postwar expenditures attributable to that wartime income were taken into account, but Congress rejected the idea of allowing a deduction for reserves. Instead, it enacted the carry-back provisions as part of the 1942 Revenue Act.[4] It felt that if a taxpayer continued to earn profits during and after the reconversion period, he did not need any special relief. The carry-backs were therefore enacted to take care of the difficult problem of allocating war caused postwar expenditures against wartime income.

d. Avoid taxing of capital as income. Finally, our tax system has been criticized as having a discriminatory effect on businesses that have not developed to the level of uniformly sound and profitable operations. Critics claim that businesses that have fluctuating incomes are not able to deduct all expenses of earning income. To this extent, the tax on net incomes becomes in part a tax on capital. Furthermore, incomes of such businesses are subjected to higher taxes than those of businesses with steady incomes. The relief afforded by the net operating loss offsets plays a vital part in the year to year determination of net income and the avoidance of taxing capital as income.

3. Significance of Net Operating Loss Adjustments

Anyone who has ever had to compute and apply the net operating loss deduction is fully aware of its complexities. However, much of the confusion may be reduced by a general understanding of the significance of the adjustments prescribed in the regulations and the law.

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[3] The Revenue Act of 1918 inaugurated this relief procedure. This was the first attempt to average out or offset the loss tax years with the profitable ones. Similar provisions were enacted in later years and in 1942, Congress enacted a two-year carry-back and a two-year carry-forward. However, experience under the law indicated that it was difficult to administer. Therefore, the law was amended in 1950 to provide for a one year carry-back and a five year carry-over.

[4] *Hearings before the Senate Finance Committee* on Sen. Rep. No. 1631, 77th Cong., 2d Sess. 51-2 (1942).

a. Economic loss concept. Under all of the pre-1954 income tax laws, the determination of a net operating loss or the loss offset deduction were governed by the "economic loss" principle of taxation. As a result, the amount allowed as a net operating loss deduction was not always the income tax loss. The regulations provided that the taxpayer make certain adjustments to limit the deduction to the "economic loss" only. For example, an examination of a taxpayer's return showed a gross income of $50,000.00 and deductions of $75,000.00, and that he received wholly exempt interest of $10,000.00 during the year. The income tax net loss was $25,000.00, but the economic loss was $10,000.00 less because of the receipt of tax-exempt interest. Therefore, the net operating loss for the year was $15,000.00 only. It was not the excess of the deductions over total income, but such excess reduced by the amount of interest which ordinarily was excluded from the calculation of taxable income, that was counted as a loss for the purpose of offsetting income of another year.

Section 122 of the 1939 Code and Regulation 111-29.122-1-5 set forth the formula for determining the amount of the net operating loss deduction. Taxwise, the loss represented the excess of allowable deductions over the statutory gross income plus interest from tax-exempt securities. In addition, individuals were required to include the full 100 per cent of the net long-term capital gains, and corporations had to include inter-corporate dividends at 100 per cent instead of 15 per cent used in the ordinary computation of corporate taxable income. Finally, the income of the years to which the loss was carried or was claimed as a deduction was similarly adjusted.

A careful examination of the "economic loss" concept of taxation revealed many defects since it was not applied with complete consistency.[5] It omitted such exempt items as the recovery of bad debts, taxes, receipts from life insurance, military pay and allowances, the surtax exemption for certain preferred dividend payments of public utilities, and other similar exemptions. On the other hand, the total income was overstated by the non-deduction of capital losses in excess of capital gains, and certain expenses deemed extraordinary, unnecessary, or otherwise non-deductible.

The House of Representatives recognized the defects in the "true economic loss" concept. On June 19, 1948, in passing the Revenue Revision Bill of 1948, it rejected this concept. However, Congress adjourned the same week without any Senate action on the bill.

b. Taxable income concept. Taxpayers are now given partial relief from the burdensome task of making the numerous adjustments required under the 1939 Code. Congress finally realized the inequity of the "economic loss" concept and partially adopted the "taxable income" concept of computing the net operating loss adjustments. First, the new Code dropped the exempt interest and percentage depletion adjustments. Then, it provided additional relief with respect to the dividends received applicable to corporate taxpayers. The net operating loss may now be computed by giving full effect to the deduction for dividends received, and no adjustment for such deduction is required in the year to which the loss is carried; nor does the taxpayer have to make adjustments for tax-free interest and percentage depletion for any intervening year through which a loss is carried. A deduction for dividends received by a corporate taxpayer in any intervening year must be computed with the limitation based on net income. Also, all other pre-1954 Revenue Act adjustments are still required for any intervening year through which the loss is carried.

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[5] Critics of the "true economic" concept contend that the loss should be determined in the same way taxable income is determined. It is inconsistent to grant a concession to such items as interest from exempt securities, long-term capital gains, intercorporate dividends, and percentage depletion, in computing annual taxable income and not to permit the same advantage in determining income over a longer period of time. Such concessions lead to inequities between taxpayers with fluctuating and those with stable incomes. For example, where two competing mining companies have equivalent production and income over a period of time, one may be denied percentage depletion where the other will obtain it. Or, of two corporations each receiving the same amount of dividends from domestic companies, one must include 100 per cent of the dividends where the other need include 15 per cent only.

The new dividends-received deduction, previously referred to, has some limitations that must be observed. The deduction cannot be more than 85 per cent of the taxable income computed without any dividends-deduction or operating-loss carryover. For example, assume that the taxpayer received $50,000 in dividends from domestic corporations. It suffered losses of $40,000 and had a taxable net income of $10,000.

Under the old provisions, no allowance was made for the 85 per cent dividends-received credit in computing the net operating loss. Under the new law, the taxpayer is entitled to a deduction equal to 85 per cent of the dividends received minus the net income. In the cited example, the deduction amounts to $32,500 ($50,000 × 85% – $10,000).

As a practical matter, the net effect of the 1954 changes is the elimination of almost all of the old adjustments, except in cases where the loss must be carried through a series of intervening years.

4. Technical Aspects of the Net Operating Loss Deduction

The computation and application of the net operating loss provisions are very cumbersome. The difficulties become more apparent when one attempts to study their consequences. To simplify their effects, some of the questions that will now be answered are (a) classes of taxpayers who may use the deduction, (b) when may the deduction be taken, (c) the types of losses that may be deducted, (d) under what operating circumstances, (e) what is the significance of the "same taxpayer" requirement, (f) is this requirement desirable or should it be modified, (g) are the net operating loss limitations uniformly applied to different classes of taxpayers, (h) what are the safeguards that have been established to check loopholes that might arise in net operating loss transactions, (i) what are the effects of the "the same taxpayer" doctrine in non-corporate cases and, (j) in cases involving corporations in liquidation.

a. Taxpayers who may use the deduction. The deduction may be used by all corporations,[6] individuals, trusts, and estates. However, with respect to the latter three classes of taxpayers, the deduction will be permitted only if the losses are incurred in connection with a regularly operated trade or business.

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[6] Businesses operating as domestic or foreign personal holding companies, regulated investment companies, corporations subject to Sec. 102 and certain insurance companies that are subject to special tax treatment may not avail themselves of the ordinary net operating loss provisions.

b. When may the deduction be taken. The taxpayer must take a deduction for a net operating loss only in the manner prescribed by law, as follows:

If net operating loss was incurred	*Carry-back*	*Carry-forward*
Before 1948	2 years	2 years
1948, 1949	2 years	3 years
1950 to 1953	1 year	5 years
1954 and after	2 years	5 years

The following table indicates the sequence of *years* that the net operating loss may be used, to the extent that it may be fully absorbed:

If net operating loss incurred in	*Carry-back to*	*Carry-over to*
1947	(1-2) 1945-6	(3-4) 1948-9
1948	(1-2) 1946-7	(3,4,5) 1949-50-51
1949	(1-2) 1947-8	(3,4,5) 1950-1-2
1950	(1) 1949	(2,3,4,5,6) 1951-2-3-4-5
1951	(1) 1950	(2,3,4,5,6) 1952-3-4-5-6
1952	(1) 1951	(2,3,4,5,6) 1953-4-5-6-7
1953	(1) 1952	(2,3,4,5,6) 1954-5-6-7-8
1954	(1-2) 1952-3	(3,4,5,6,7) 1955-6-7-8-9

For instance, a net operating loss for 1954 is used until exhausted in the following years in the order stated: 1952, 1953, 1955, 1956, 1957, 1958, 1959. This sequence must be followed. Thus, there can be no carry-over to 1955 until 1952 and 1953 incomes have been absorbed.

The extension of the carry-back provision to two years is very significant at this time. Under the new 1954 law, a taxpayer could carry-back his 1954 loss against the income profits of 1952 and 1953. As a result, the taxpayer may file for refunds of part of the taxes paid in 1952 and 1953, thereby enabling his business to continue. It is noted, however, that the two year carry-back applies to income tax only. A 1954 loss may not be carried back to obtain refunds of 1952 excess profits taxes, although it could be used for refunds of 1953 excess profits. The latter refund is made possible by the provisions of the 1939 Code. Therefore, it is further noted that a net operating loss arising in 1955 will not have any refund possibilities with respect to excess profits taxes.

c. Business losses versus non-business losses.[7] In cases of individuals and other non-corporate taxpayers, the net operating loss deduction is limited to losses due from the conduct of a trade or business regularly carried on by the taxpayer. This is so despite the fact that all of the revenue acts have provided in one form or another for the deduction of the "ordinary and necessary expenses paid or incurred in carrying on a trade or business." Whether an activity of the taxpayer amounts to the "carrying on of a trade or business" requires an examination of the facts in each case. No regulation or Treasury decision has ever defined this term and most of the courts have avoided giving it any definition or formula.[8]

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[7] Important among the adjustments required in the computation of the net operating loss are: (a) business capital losses may not exceed business capital gains and that part of the excess of the non-business capital gains over non-business capital losses not used in (c) below; (b) non-capital losses may not exceed non-business capital gains; (c) ordinary non-business deductions may not exceed ordinary non-business gross income and the excess of non-business gains over non-business capital losses. Reg. 111, Sec. 29.122-3(a)(5)(6)(7).

Prior to 1942, a considerable amount of litigation existed regarding the status of individuals and fiduciaries as being engaged in a "trade or business." In *Higgins* v. *Commissioner*[9] the Supreme Court ruled that the management of a taxpayer's own investments, no matter how large the estate or how continuous or extended the work required might be, did not as a matter of law constitute the carrying on of a trade or business. In another leading case,[10] the Court held that the management of securities held in trust for another, like the management of one's own securities, should be denied the status of a business. Because of the rigid interpretation by the Court in these cases, Congress enacted Section 23(a)(2) as part of the Revenue Act of 1942.[11] The regulations adopted in pursuance of this section prescribe the type of non-business expenditures that are now deductible.[12]

Significant in the application of Section 23(a)(2) is the issue of its relation to Section 23(a)(1).[13] Construction of this issue is found in *McDonald* v. *Commissioner*,[14] relating to the deductibility of state election campaign expenses. In a 5 to 4 decision, the majority of the Supreme Court held that the amendment of 1942 merely enlarged the category of incomes with reference to which expenses were deductible. It did not enlarge the range of allowable deductions of "business expenses." The minority view argued for the deduction of all non-personal expenses that are ordinary and necessary in the taxpayer's efforts to produce income. It seems discriminatory to restrict them to types of expenses that would ordinarily be deductible as "business" expenses. However, in other court actions the decisions have not deviated from the majority construction. It is doubtful they will change without further legislative action.

A study[15] by the technical staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation recognized these types of inequities. It indicated that the tax base for tax assessment should be income received plus or minus changes in net worth. Taxpayers other than corporations must include the change in their net worth in their income for the period of assessment. Therefore, it seems reasonable to permit partners and individual proprietors to deduct losses from other income as long as all profits, whether distributed or not, are included in income.

Congress has partially remedied this situation. The Revenue Act of 1951 for the first time allowed non-corporate taxpayers to carry-back non-business casualty losses to other years. Thus, if an individual suffered a $15,000.00 loss to his residence due to a storm or fire, and he had only operating income of $7,000.00, he could under the 1951 law, carry-back the $8,000.00 income tax loss to 1950. Further, any unused part of the $8,000.00 loss could also be carried forward and applied against the profits of the next five years, until it is completely exhausted.

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[8] In *Flint* v. *Stone Tracy Co.*, 220 U.S. 107, 171 (1910), the Supreme Court defined a business as that "which occupies the time, attention and labor of men for the purpose of a livelihood or profit." See also *Deering* v. *Blair*, 23 F. 2d 975 (App. D.C. 1927). Since most corporations are unquestionably organized for business purposes, lack of the profit motive as a ground for disallowance is likely to occur only in cases where the property of the corporation is operated solely for the pleasure and recreation of its stockholders, *Savarona Ship Corp.*, 1 TCM 89 (1942): *Black Dome Corp.*, 5 TCM 455 (1946).

[9] 312 U.S. 212 (1941).

[10] *City Bank Farmers Trust Co.* v. *Helvering*, 313 U.S. 121 (1941).

[11] Sec. 121 of the Revenue Act of 1942. 77th Cong., 2d Sess. (1942).

[12] Reg. 118, Sec. 39.23(a)-15. Typical items include safe deposit box rentals, custodian fees, trustees fees and commissions, clerical help, fees for services of counsel, etc.

[13] H. R. Rep. No. 2333, 77th Cong., 2d Sess. 75 (1942).

[14] 323 U.S. 57 (1944).

[15] Study of Business Loss Offsets, Treasury Department Press Release, 10-24-47.

d. What law controls. In computing the net operating loss the problem frequently presents itself whether to apply the law of the year in which the loss originates or the law of the year for which it may be used as a deduction. On the surface this would seem to be a matter that could easily be determined, but such is not the case. The difficulty stems from the fact that a change in law due to a new Revenue Act may not clearly define the date that a particular provision is to become effective in relation to other operative provisions in the law. Since the net operating loss involves multiple statutory adjustments, the possibilities of being confronted with such difficulties seem to be more acute.

The difficulties that may present themselves are illustrated by a recent change in the law. Under prior law, one of the adjustments that were required in computing the net operating loss deduction, was that long term capital gains and losses be taken into account at 100% instead of 50%. There is no such requirement under the amendments by the 1951 Act, because under that Act long-term capital gains and losses are taken into account at 100% on the return. The 1951 Act, however, provided for a new adjustment (disallowance of the deduction under Sec. 23(ee)). That deduction is 50% of the excess of the net long-term capital gain over the net short-term capital loss. Therefore, under the *Reo Motors, Inc.*[16] case, taxpayers compute the net operating loss for 1951 and prior years under the old law and the net operating loss for 1952 and subsequent years under the new law.

In the *Reo Motors, Inc.* case, the taxpayer sustained a loss resulting from the worthlessness of a subsidiary stock. Under Section 23(g) as constituted in 1941, such a loss was a capital loss, but under Section 23(g) as constituted in 1942, it was an ordinary loss. The question presented was whether Section 23(g)(4) as added by the Revenue Act of 1942, applicable to taxable years beginning after December 31, 1941, would be given retroactive effect making losses like the one in question ordinary ones. Judge Hill indicated that since the deduction was a 1941 deduction it could not be controlled by the law applicable to 1942. The determination whether the loss existed must be made under 1941 law. The deductibility of the carry-over aspect would be dependent upon the 1942 law.

In the *Cambria* case[17] the taxpayer used the percentage method of computing depletion. Section 145(a) of the Revenue Act of 1942 amended the law so as to grant for 1942 and later years the larger of the depletion allowances computed under cost or percentage methods. The taxpayer was not entitled to any deduction for 1943 under the percentage method and therefore it took, as the law applicable for 1943 provided, the deduction computed under the cost method. As a consequence, it had a net operating loss for 1943 which it used in computing its net operating loss deduction for 1941. The Commissioner proposed to compute the 1943 loss under 1941 law, since the deduction would not have been allowable for 1943, but for an amendment to the Code. However, the Court held that deductions in computing a net operating loss are determined under the law applicable to the loss year rather than the law applicable to the year for which a net operating loss deduction is allowed.

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[16] 9 T.C. 314 (1947).

[17] *Cambria Collieries Co.*, 10 T.C. 1172 (1948).

After many other controversies, court decisions now have established the rule that the determination of the amount of the net loss for a particular year will be governed by the law applicable to that year.[18] This rule has now been enacted into law by virtue of Section 172(e) of the 1954 Code.

e. Significance of *New Colonial Ice Co.* v. *Helvering*. From 1921 to the end of 1953, a successor taxpayer could not take a deduction for a net operating loss suffered by its predecessor. This conclusion is based on the Supreme Court decision in *New Colonial Ice Co.* v. *Helvering*.[19] In that case, the Court determined that a net loss deduction permitted by Section 204(b) of the Revenue Act of 1921 is personal to the "taxpayer" and not transferable or usable by another. Although the language of the present Code covering a net loss deduction is not exactly the same as Section 204(b) of the 1921 law, the general purposes of the provisions are similar. Therefore, the language of the Court in that case would seem to have equal application to the current loss provisions.

f. The corporate or separate entity doctrine. The "same taxpayer" concept is a segment of the corporate or separate entity doctrine. Both corporate and tax law generally recognize the concept of separate entity. There is, however, much doubt concerning how it will be applied to a particular set of circumstances.[20] Although each case must be determined on its own particular facts, certain general principles are evident. These are: (a) the corporate entity will be upheld unless some strong reason of policy dictates disregard thereof;[21] (b) a successor corporation is not the same entity as its predecessor for tax purposes;[22] (c) the taxpayer's effort to disregard a corporate entity will almost invariably fail in absence of specific statutory authority;[23] (d) the Commissioner may assess taxes against a corporate entity no matter what the motives for incorporating it may have been or how informally it has conducted its affairs;[24] and (e) in special cases he may also disregard the entity if it is unreal or sham.[25]

g. Merger temporarily avoids "same taxpayer" requirement. It has often been stated that a rule of law proves its soundness and value by the length of time it has been upheld by the courts and accepted by the public. This is certainly true of the rule disallowing net operating loss offsets to one other than the "same taxpayer" who suffered the loss. This rule has held steadfast despite taxpayer's attempts to circumvent it by showing that the successor taxpayer was "substantially the same" as its predecessor.[26]

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[18] For example, in case the law is amended between 1951 and 1952 and a 1951 loss is to be carried over to 1952, the amount of the 1951 loss is determined under the law applicable in 1951, but the amount of the carry-over that is allowed as a deduction in 1952 will be determined under 1952 law.

[19] 292 U.S. 435 (1934).

[20] A noted authority stated, "It is clear beyond peradventure that no guiding principle can be stated which will explain even most of the cases. On the contrary, it might with confidence be stated that as far as a specific problem is concerned, the prediction of the judicial attitude is entirely beyond the power of the legal mind." Finkelstein, *Corporate Entity and the Income Tax*, 44 *Yale L. J.* 436, 447-8 (1934).

[21] *Deputy* v. *Du Pont*, 308 U.S. 488 (1940).

[22] *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435 (1934).

[23] *Munson S.S. Line* v. *Commissioner*, 77 F. 2d 849 (CCA 2d) (1935); *Continental Oil Co.* v. *Jones*, 113 F. 2d 447 (CCA 10) (1940).

[24] *Texas-Empire Pipe Line Co.* v. *Commissioner*, 127 F. 2d 220 (CCA 10) (1942).

[25] *Moline Properties, Inc.* 319 U.S. 435 (1943); *Higgins* v. *Smith*, 308 U.S. 473 (1940).

In spite of the seemingly insurmountable obstacles, the facts developed in recent practices opened the door to its fulfillment. A widespread rash of mergers developed, whereby profitable firms acquired control of corporations that were losing money, for the purpose of offsetting the gains of the former against the losses and the loss carry-overs of the latter. The net effect to the participants was substantial savings in income taxes. It was difficult to check this practice with the existing law of the time (see *j. Effect of Section 129*, below).

Business reports indicate that in 1953-5 several thousand companies contemplated or went through a merger type of reorganization. Of course, the tax-avoidance purpose was not the principal motivating force in all of these cases. With the return of a buyers' market, many firms just could not stand the pace of mass production competition. They could not meet their overhead costs or expenses necessary to survive the changing trends. Thus, the current Kaiser-Willys, Nash-Hudson and Packard-Studebaker mergers show that even companies with more than 100 million dollars in assets had to merge in order to stay in business. This practice was especially noticeable in the airline, car, automobile parts, bank, chain and department store, shipping, steel and iron industries. Most economists indicate that the competitive pressure and a desire for product diversification were the basic reasons for the "urge to merge." They point out that a good way to smooth out the ups and downs of business cycles on a company's earnings is by acquiring an operation with either a non-cyclical or a different cyclical pattern.

In a leading test case,[27] a parent company absorbed its subsidiary in a statutory merger. Prior to the merger, the subsidiary had a sizable unused excess profits tax credit. After the merger, the parent applied this credit as a carry-over to reduce its excess profits tax income. The Commissioner argued that the unused credit of the dissolved company was lost because the subsidiary lost its identity in the merger. The Court held, however, that the surviving parent company was a "union of component corporations into an all-embracing whole which absorbs the rights and privileges, as well as the obligations of its constituents."

The Court specifically referred to the *New Colonial Ice Co.* case. It said there was a distinction between (1) a reorganization where the successor corporation takes over its predecessor by purchase and contract and (2) one where the successor takes over by operation of law. Under this reasoning it is the type of reorganization that controls, and since there was no merger in *New Colonial Ice Co.*, it does not apply.

h. Congress closes tax-avoidance schemes. Will the merger type of reorganization, with its evident defects, be allowed to continue without adequate income tax revenue safeguards? The answer is "No."

The Tax Court has already refused to follow the Stanton decision in the recent case of *California Casket Co.*, 19 T.C. No. 7, 10-15-52. More significant is the action taken by Congress in enacting Sections 269 and 382 of the 1954 Revenue Act. These new provisions hold that there is a presumption of intent to avoid income taxes whenever the amount paid for the property is substantially out of proportion with the value of the property acquired. The new rule is much more definite than the provisions incorporated in Section 129 of the old code. Specifically, the new law provides that disproportionate benefits in a merger reorganization transaction will be prima facie evidence that the principal purpose is tax avoidance. The taxpayer will be required to show by a clear preponderance of the evidence that the principal purpose of the acquisition was not merely to obtain tax benefits. This burden of bringing in the evidence is now on the taxpayer rather than on the government.

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[26] This proof has justly been held to be insufficient since different entities, though entirely similar, remain separate and distinct.

[27] *Stanton Brewery* v. *Commissioner*, 176 F. 2d 573 (CCA 2) (1949), reversing 11 T.C. 310 (1948).

Further, use of a loss carry-forward may be barred or cut down where there is a substantial change in ownership of a closely held deficit corporation. The statute has defined "closely held" as any company 50% of whose stock is owned by ten or less shareholders. The loss carry-over will be reduced, by prescribed statutory formula, if there is a 50% or more change in corporate ownership within a period of two taxable years. Thus, if any one or more of the ten persons owning the greatest percentage of stock at the end of the taxable year also owned less than 50% at the beginning of the year or the beginning of the previous year, the carry-over would be reduced by the percentage of change in ownership. As a result, if a taxpayer bought 100% of the stock of a loss corporation and used it to operate his profitable business, no operating loss carry-over will be allowed.

The new law, however, does not bar the owners of a loss corporation from buying a profitable company and operating it through their deficit corporation. Apparently this would not jeopardize the loss deduction since there is no 50% change of ownership in the deficit corporation. It is also noted that changes in ownership caused by gifts, bequests or similar exchanges would not have any effect on the loss deduction.

The above provisions are applicable to reorganizations occurring after March 1, 1954.

i. Reorganized railroads allowed special relief. In 1947, Congress enacted a special measure granting relief to certain successor railroads that had been involved in bankruptcy or receivership proceedings and were compelled under state law to use a new charter pursuant to the reorganization. The new law allows these railroads the benefit of the net operating loss and unused excess profits carry-overs derived from their predecessors. The regulations governing these provisions are contained in T.D. 5642 C.B. 1948-2, page 70. To date, this is the only statutory exception to the "same taxpayer" rule.[28]

j. Effect of Section 129.[29] Prior to 1944, there were numerous acquisitions of controlling interests in certain corporations for the purpose of avoiding income or excess profits taxes. Tax savings could be realized when a taxpayer acquired the assets or control of another corporation and thereby (a) obtained the benefits of a deduction or a credit which belonged to the acquired corporation, or (b) created a credit or deduction as a consequence of its own operations, or (c) utilized the benefit of a credit or deduction which it already had but could not use without such acquisition. For example, the B corporation had assets with a basis far in excess of their fair market value. The A corporation, with full knowledge of this fact, merged with B hoping thereby to offset the depreciation deductions of the over-valued assets against its own (A's) income. Or a corporation with high earning assets transferred them to a newly organized subsidiary. It retained the assets likely to produce losses, for the purpose of obtaining refunds by the creation of a net operating loss carry-back or unused excess profits carry-back. Or the acquiring corporation, anticipating a current loss, acquired an income-producing business as an offset for such losses.

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[28] The Treasury Department expressed no objection to this legislation since, very little of this tax liability having been collected, tax refunds would not be too great. This reason, hardly adequate in itself, was bolstered by a belief that the law would help remove the barriers holding railroads in receivership and enable them to develop profitable taxpaying operations.

[29] This Section of the Code was added by the Revenue Act of 1943 to prevent the avoidance or evasion of taxes resulting from loss-type transactions during taxable years beginning after 1-1-44. The section becomes operative *only* if the purpose of acquisition to avoid taxes is paramount over other purposes.

There has been very little judicial interpretation of Section 129 since its enactment. However, an examination of the available cases indicates that the Tax Court has applied Section 129 limitations very literally. In *Commodores Point Terminal Corp.,*[30] the Commissioner was unsuccessful in establishing that a corporation that acquired a controlling interest in another corporation had obtained any tax benefit thereby or that the principal purpose of the transaction was to avoid taxes. The *Alprosa Watch Co.*[31] decision discusses Section 129 by way of dicta. Even though the facts involved in this case occurred prior to enactment of the section, it highlights the type of transactions that may be subject to attack. On June 14, 1943 the stockholders of the Esspi Glove Co. sold all of their stock to two persons, neither of whom had previously been connected with the corporation. The name of the company was then changed to Alprosa Watch Co., the business was moved, and the nature of the business was converted from the manufacture and sale of gloves to the purchase and sale of jewelry. Alprosa claimed that Esspi and Alprosa were one and the same taxable entity and therefore it could include in its returns the income and losses realized by Esspi during the preceding years and claim the benefit of the latter's excess profits credit. The Court, in upholding the taxpayer, found as a fact that ". . . the acquisition of an existing corporation was necessary . . . and while we are satisfied that the parties in interest were not unaware of the tax advantages that might accrue through Esspi, the record does not support a finding that tax avoidance was the dominating motive." [32]

Since the effect of Section 129 on net operating losses proved to be very limited, Congress enacted the additional safeguards set forth in Secs. 269 and 382 of the 1954 Code, previously discussed.

k. "Same taxpayer" doctrine also applicable in non-corporate taxpayer cases. Generally, all non-corporate taxpayers who are engaged in a trade or business are entitled to the benefits of the net operating loss deduction.[33] An individual may be engaged in more than one business at a time and the loss need not merely result from the principal business in order to be treated as a net operating loss. As previously noted, it is merely necessary that the various activities or enterprises of the taxpayer be "regularly carried on" and not merely be occasional or isolated.

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[30] 11 T.C. 411 (1948).

[31] 11 T.C. 240 (1948).

[32] 11 T.C. 240, 245 (1948).

[33] Sec. 122(d)(5) of the Code.

However, the taxpayer identity must be observed. Thus, a decedent and his estate are different taxpayers and therefore one cannot avail itself of the other's net operating losses.[34] Similarly, ordinary trusts and beneficiaries are separate entities and the net operating loss of one cannot be used by the other.[35] Nor may a sole stockholder of his corporation have the benefit of losses sustained by the corporation.[36]

In the case of a partnership, each partner is permitted to take his share of the partnership's net operating loss as a carry-back or carry-forward to the allowable prior or subsequent years.[37] Similarly, members in a common trust fund may use their proportionate share of the loss suffered by the trust.[38]

l. Corporations in reorganization. As previously noted, the Court in the *Alprosa Watch Co.* case also held that the proprietary ownership and nature of the corporate business activities may be changed entirely without losing the benefits of the carry-over of the net operating loss deduction that arose prior to the change. Note, however, that the "corporate entity" remained intact and continuous.

Prior to the enactment of Sec. 381 of the Revenue Act of 1954, where a new "corporate entity" resulted from a reorganization, the benefits of the net operating loss deduction carry-over were generally denied the successor even though the same "economic entity" continued. Since the corporate entity changed, the deduction could not be taken. Apparently, it made no difference whether the reorganization was taxable or tax free.[39]

As a result of these obstacles, many reorganizations suffered. Corporations used the merger instead of the consolidation method of reorganization. Others organized without taking the business factors into consideration.

To overcome these difficulties, Congress set up specific rules how a successor corporation could step into the "tax shoes" of its predecessors via a tax free reorganization or liquidation. The specific items that the successor company could use are enumerated in Sec. 381 of the 1954 Code. Tax results of such reorganizations are thereby made to depend less upon the form of the transaction than upon the economic integration of two or more separate businesses into a unified and possibly more vitally progressive enterprise. At the same time, the new provisions make it difficult to escape the tax consequences of the law by means of legal manipulation such as liquidation and reincorporation or merger into another corporation.

5. The Effect of Liquidation on the Loss Offset Provisions

a. Corporate taxpayers. Should the carry-back, carry-forward provisions be allowed while a business is in the process of liquidation, or should these provisions be applicable to a continuing business only? These questions were dealt with by the courts in a number of recent decisions. In the *Acampo Winery and Distilleries*[40] case, the taxpayer was in the process of liquidation during 1944 and 1945. It sought to carry back losses incurred during these years to 1943. The Commissioner contended that a corporation which had losses during years it was in the process of liquidation was marking time and was not entitled to carry back such losses to prior years. He argued that Congress intended to allow the deductions only where the same taxpayer was continuing to carry on substantially the same business in the loss years that it carried on in the taxable year that the deduction was claimed. However, the Commissioner cited no authority to support his position, and the Tax Court held for the taxpayer. It indicated that "The words of the statute are general in their application and something would have to be read into them which is not there to limit them so that they would not apply in this case." [41]

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[34] *Estate of R. R. Russell,* 34 B.T.A. 715 (1936).

[35] *George W. Vreeland,* 16 T.C. 129 (1951).

[36] *Dalton v. Bowers,* 287 U.S. 404 (1932); Henry Dillon Whiship, 8 T.C. 744 (1947).

[37] *Jerome Burr,* 11 B.T.A. 1005 (1928).

[38] Sec. 170 of the Code.

[39] Supra, note 19.

The deduction would also seem to be allowable on the basis of analogous situations in which taxpayers have been allowed a deduction of a business expense or loss paid or incurred after ceasing to do business. Thus, in *Edgar L. Marston*,[42] a loss was allowed a former partner for payment of partnership liability two years after dissolution of the partnership. The loss was held to result from the operation of a business, regardless of whether the taxpayer was engaged in active business in the year of the loss. Therefore, it was allowed as a carry-over to the succeeding year.

The Court did not follow these principles in the *Wier Long Leaf Lumber*[43] case. In this case, the taxpayer sold its entire plant and equipment for cash at the close of 1942. It continued in existence during 1943 and 1944 for the purpose of liquidation. It had a substantial unused excess profits credit in those years, which it sought to carry back to 1941 and 1942. A literal reading of Section 710(c)(3)(A) would seem to permit the taxpayer to carry back such unused excess profits credits. However, the Tax Court rejected such a position. It indicated that the carry-back was intended by Congress to benefit only corporations that had been in active production in the war period and had projected their activities to peacetime years. However, the appellate court disagreed with this conclusion. "The fact of liquidation and the particular circumstances and stages of it are relevant . . . and if it appears that the corporation is a corporation in name and semblance only . . . it must, though not formally dissolved, be treated as dissolved *de facto*." [44] Until the liquidation has reached a point where there is no corporate purpose to be served in delaying dissolution, it is considered to be a going corporation and entitled to the benefits of the carry-back. Based upon this reasoning, the Court allowed the taxpayer to carry back the credit from 1943. However, at the close of 1943, the liquidation had progressed to the point where there was no longer any valid reason for delaying dissolution, and in 1944 the corporation was considered to be *de facto* dissolved. Consequently, the carry-back from 1944 was disallowed.

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[40] 7 T.C. 629 (1946).
[41] 7 T.C. 629, 640 (1946).
[42] 18 B.T.A. 558 (1929).
[43] 9 T.C. 990 (1947).
[44] 173 F. 2d 549 (CCA 5) (1949), modifying 9 T.C. 990 (1947).

Examination of the net operating loss carry-back and the unused excess profits credit carry-back provision indicates the wisdom of these decisions. Certainly, the cost of going out of business is a legitimate expense and in the majority of situations a corporation will not intentionally incur a net operating loss. The situation is entirely different with respect to the unused excess profits carry-back. If a taxpayer ceased all operations during a taxable year, its excess profits credit would still be the same as if it had continued operations. However, its income would be zero and therefore it would have an unused excess profits credit, which could be carried back to earlier years for the purpose of reducing taxes. The possibility of tax avoidance by merely postponing liquidation and marking time for a number of years should not result in recovery of wartime income and excess profits taxes.

Since most of the existing practices rest on court made law that is often uncertain and frequently contradictory, Congress enacted Sec. 381 of the Revenue Act of 1954 setting up specific rules for carrying over certain tax benefits, such as the net-operating loss deduction, in case of certain tax-free liquidations.

b. Other taxpayers. *Pre-1954 rules:* Taxpayers other than corporations have not been accorded the same benefit of carrying back losses incurred in the sale or liquidation of their properties. This is due to the interpretation of Section 122(d)(5), which provides that in computing a net operating loss for an individual "deductions otherwise allowable by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall be allowed only to the extent of the amount of gross income not derived from such trade or business." The difficulty in this provision is to meet the test of "regularly carrying on a trade or business." The Commissioner and the courts[45] have consistently held that unless the taxpayer is regularly engaged in the business of selling or liquidating the type of asset or business for which a loss is claimed, such a loss will be treated as resulting from an isolated transaction. As a consequence, it may not be carried back or forward as part of a net operating loss.[46]

Examination of these and other cases indicated that taxpayers other than corporations were being discriminated against. It seemed that such losses sustained by an individual on the liquidation or sale of all or part of his business might well be allowed as a carry-back or carry-forward. If the carry-back and carry-forward provisions were intended to apply to the operation of a business only, neither the liquidation losses of a corporation nor the losses sustained on the sale of a business by an individual should be allowed. However, if they were intended to be general averaging devices, both should be recognized. In any case, it became evident that the same policy should be applied to all taxpayers without discrimination against any group.

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[45] *Joseph L. Merrill,* 173 F. 2d 310 (CCA 2.) (1949) affirming 9 T.C. 291 (1947); *Foreman* v. *Harrison,* 79 F. Supp. 987 (N.D. Ill., 1948); *Joseph Sic* (CCA 8) (1949) affirming 10 T.C. 1096 (1948).

[46] In *Lazier* v. *United States,* 170 F. 2d 521, 526 (CCA 8) (1948), the Court questioned the wisdom of these cases. It said, "It is possible that the Commissioner, the Tax Court and the District Courts, which have approved the Commissioner's determination of the statute, may have misconceived the intent of Congress with respect to the character of net losses which could be carried forward or back. No doubt, that intent could have been expressed in simpler and more understandable language. A petition for certiorari to the Supreme Court should enable that court to give the question nationwide repose."

1954 rules: Congress corrected another inequity by enacting subsection (d)(4)(A) of Sec. 172 of the Revenue Act of 1954, by providing that losses suffered by individuals on sales of machinery, buildings, etc., may be carried back and forward as part of the net operating loss deduction. Thus, for the first time, a non-corporate taxpayer may take advantage of this relief provision whether he sells the entire business or only one or more of the business assets and the business continues.

6. Procedure and Practice Problems

Generally, a claim for refund of income or excess profits taxes must be filed within three years from the due date or actual filing date of the tax return. A different period of limitation is prescribed with regard to claims involving overpayments due to carry-backs of net operating losses or unused excess profits credits. The limitation period for filing refund claims in such cases is the period which ends with the expiration of the 15th day of the 39th month following the end of the taxable year in which the loss or unused excess profits credit originated.

a. Acceleration of refunds due to carry-backs. An accelerated refund procedure[47] has been established with respect to refund of prior years' taxes which are due to carry-backs of net operating losses originating during any taxable year ending on or after September 15, 1945. This procedure was set up to eliminate the delay that existed in examining and auditing the refund claims. The relief afforded corporate taxpayers enables them to obtain refunds within 90 days, or to apply the contemplated refund as a payment for current unpaid tax installments. Under the latter alternative the deferred taxes bear interest, and if the amount of tax which is deferred is in excess of 125 per cent of the net refund ultimately ascertained, the excess is subject to a penalty of 5 per cent. Taxpayers other than corporations who expect to sustain business losses that may be carried back to prior years, may also obtain 90 day pre-audit refunds, but do not have the privilege of deferring unpaid installments of a currently due tax.

To obtain relief in the nature of a tax deferment (Form 1138) or pre-audit refunds (Form 1139 for corporations; Form 1045 for other taxpayers) proper applications must be filed. Forms 1139 and 1045 are based on exact figures and must be filed on or after the date of filing the return for the taxable year in which the carry-back originates. Form 1138 is based on estimated figures and is filed during the taxable year in which the taxpayer expects to sustain the loss.

b. Interest on refunds. A taxpayer is ordinarily entitled to 6 per cent interest on refunds from the date of overpayment. If the overpayment results from the carry-back of a net operating loss or of an unused excess profits credit, no interest is allowed for any period before a claim for refund is filed or a petition is filed with the Tax Court, whichever is earlier. Other special rules for the allowance of interest on applications for tentative carry-back adjustments are provided by Sections 4(a) and 6(b) of the Tax Adjustment Act of 1945.

The application of the carry-back provisions of Section 122(b) abolishes the right of the Commission to collect tax deficiencies legally assessed in a prior applicable year, but does it also abolish the right to collect interest on such deficiencies? A recent Circuit Court decision,[48] in overruling the lower Court, held that it did. The Commissioner argued that the money was due when the deficiency was assessed and therefore the Government was entitled to interest on the difference between its claim and what the taxpayer had paid, until the debt due was absolved by the carry-back. The taxpayer contended that it did not owe interest for non-payment of deficiency taxes which, in the light of subsequent events, were found not to exist. The taxpayer also relied on case authorities which allowed recovery of interest paid either on tax assessments which were later shown to be erroneous, or in connection with a compromise agreement with the Government. The Court therefore concluded that "interest on nothing is necessarily nothing."

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[47] Sec. 4(a) of the Tax Adjustment Act of 1945.

The holding of the Court seems to stem from the proposition that since the taxpayer did not claim any interest from the Government, the latter should not exact any interest from it. However, this reasoning is not in accord with the principle that the exaction of interest from the Government requires specific statutory authority in force at the time of the allowance of a refund or credit. Furthermore, the net operating loss carry-back that the taxpayer eventually became entitled to deduct resulted in the abatement of a deficiency that was in existence for a considerable length of time. During this time, the Government was legally entitled to its interest. It would seem that the interest consequences of a taxpayer's liability should be applied in a chronological and orderly manner.

c. Separate or joint returns. No simple rule can be set forth which will determine the advisability of joint or separate returns.

Where separate returns are filed in the loss year, but joint returns in the year of the carry-back deduction, the separate losses of each spouse are totalled. However, if one has a loss and the other spouse a gain in the current year, the loss is carried back to the prior joint return, but the gain is reported on the other spouse's current separate return. No set-off is permitted.

If a joint return is filed in the loss year, but separate returns in all deduction years, each spouse claims his respective portion of the loss reported on the joint return. The objective is to obtain the full tax benefits of the separate or combined losses.

With respect to carry-over of capital losses, the following rules should be observed:

1. The net capital loss is limited to $1,000 on a joint return, although each spouse could deduct $1,000 on separate returns.
2. For joint returns, each spouse must compute the separate gain or loss. A net loss of one will apply against a net gain of the other.
3. Capital loss carry-over from a joint return to separate returns is determined from the separate computations of the joint return. Each spouse uses the loss allocated to him as a short-term capital loss.

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[48] *Seeley Tube & Box Co. v. Manning*, 172 F. 2d 77 (CCA 3) (1948), reversing 76 F. Supp. 937 (1948).

4. Capital loss carry-overs from separate returns are combined on a joint return and treated as a short-term capital loss.

d. Separate or consolidated returns. The rules for determining consolidated net operating loss deductions are prescribed by Regulation 129. The problem of determining them is purely arithmetical.

However, the treatment of the net operating loss in instances where separate returns were filed and then the taxpayer sought to carry-over the net operating loss of the separate year return to a consolidated return year is quite different.

In *Capital Service, Inc.*,[49] the taxpayer filed a separate return for the year 1941 showing a net operating loss. In 1943, it filed a consolidated return with its subsidiary. The latter company had all of the income in 1943 and the parent company had none. Therefore, the court held that the operating loss of the parent could not be applied against the consolidated income.[50]

A recent California decision[51] has once again raised the problem of whether a CPA, admitted to practice before the U.S. Treasury Dept., was practicing law by studying certain law points relating to the deductibility of a net operating loss that he claimed on a return prepared by him for a taxpayer. The Court held that the preparation of the return did not constitute the practice of law. However, by claiming the loss as a net operating loss, and then pressing his point with the revenue agents who challenged it, constituted the practice of law. The question of whether the loss qualified as an operating loss was a question of law and not of accountancy. Further, the Court refused to accept the suggestion of the *Bercu* decision[52] that an accountant may properly deal with legal questions "incidental" to the preparation of returns.

Since the Treasury Department and the Tax Court cannot preclude the state courts from regulating the practice of law in their states, the Court finally said, "as a federal constitutional question is here presented, the avenue is open to a review by the Supreme Court of the United States."

7. Conclusion

This review of some of the major questions to which the net operating loss deduction gives rise, illustrates that even so restricted an attempt to provide tax relief has resulted in numerous and diverse complications.

It is readily apparent that the provisions of the tax law governing the use and application of the net operating loss deduction have been improved by the new legislative enactments in 1954. Furthermore, this was done without sacrificing the sound purposes for which they were originally enacted.

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[49] 180 F. 2d 579 (CCA 9) (1950), affirming 8 TCM 459 (1949).

[50] This decision was rendered on the basis of Regulation 104, Sec. 23.31(d)(3), which provided that a net operating loss carry-over from a separate return year shall not exceed the sum of the corporate net income and separate net capital gain included in the consolidated net income tax year.

[51] *Agran* v. *Shapiro*, Appellate Department, Superior Court, Los Angeles County, Calif. (6-14-54).

[52] *In re Bercu*, New York Supreme Court, Appellate Division, First Dept.; 78 N.Y.S. 2nd 209 (1948).

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Embezzlement and Theft Losses

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Among the deductions allowed to taxpayers by the Internal Revenue Code are those for losses sustained during the taxable year and not compensated for by insurance or otherwise.[1]

In the case of an individual taxpayer, uncompensated losses are deductible only if (a) incurred in trade or business, or (b) incurred in a transaction entered into for profit, or (c) if they arose from fire, storm, shipwreck or other casualty, or from theft.[2] There is no restriction in the Code on the kind of losses which may be deducted by corporations.

The loss provisions of the Code furnish the statutory authority for the deduction of losses occasioned by embezzlement or other dishonest conduct which may be regarded as theft.[3]

1. Points to Consider

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Effect of insurance 7

2. What Constitutes Theft?

It is immaterial whether the nature of the crime is larceny, embezzlement, obtaining money under false pretenses or otherwise, so long as the loss results from conduct which amounts to theft.[4]

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[1] 1954 IRC § 165; 1939 IRC § 23(e), (f).

[2] 1954 IRC § 165(c); 1939 IRC § 23(e).

[3] But see *Black* v. *Bolen* (D.C., W.D. Okla. 1920), 268 Fed. 427, 2 AFTR 1270, where the taxpayer made profits through speculating in stocks and these profits were embezzled by his broker. The court held that since the profits were not received by him they were not income. The loss was, in effect, allowed as an adjustment to income, not as a deduction.

[4] *Curtis H. Muncie*, 18 T.C. 849 (1952); *The Morris Plan Co. of St. Joseph*, 42 B.T.A. 1190 (1940) (Acq.). In *Thomas Miller*, 19 T.C. 1046 (1953) (Acq.), the taxpayer paid a contractor a substantial portion of the price agreed for the construction of a dwelling. The contractor abandoned the job and disappeared after doing only a small part of the work. It was held that the taxpayer sustained a loss deductible under § 23(e)(3) as the result of a "felonious absconding."

A criminal intent is an essential element of theft or embezzlement. Funds retained by an agent without concealment and under a claim of right are not embezzled, and it does not matter whether or not the claim is well founded.[5] Losses from improvident loans made by bank officials are not embezzlement losses in the absence of fraud,[6] or where not made furtively or surreptitiously.[7] The mere fact that money is lost, without evidence as to how it disappeared, will not support a claim that it was stolen.[8] The taking of jointly owned United States savings bonds by a wife does not constitute a loss by theft.[9]

3. There Must Be an Actual Loss Sustained

The deduction will only be allowed if actual and if sustained by the taxpayer. Theft of property in the possession of the taxpayer but not owned by him does not establish any deductible loss. Where the taxpayer holds funds in trust, which are stolen or embezzled from him, the taxpayer has not yet sustained any loss. He is not yet out-of-pocket until he makes good to the beneficial owner. The mere creation of liability on the part of the trustee for the amount misappropriated does not create a certainty of loss, as the defalcation may be made good by the one who caused it or the liability of the taxpayer may not be enforced. Thus, in such a case there is no deductible loss in the year of theft, but rather, in the year in which the taxpayer makes restitution.[10]

Where a stockholder-officer of a bank voluntarily makes restitution of funds embezzled by an employee, he does not sustain any deductible loss because (1) the funds embezzled are not his and (2) he is under no legal liability to pay the loss. If he were legally bound to make the loss good, the amount paid would be considered to be a capital contribution and hence additional cost of his stock.[11]

Obviously the taxpayer has no theft or embezzlement loss where he consents to the misappropriation or misapplication of funds or property.[12] Where corporate funds or assets are "informally" abstracted by a managing officer, who is a substantial stockholder or who is closely related to the stockholders, the question whether the corporation has sustained a deductible embezzlement loss has arisen in the courts in a number of cases.

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[5] *Bula E. Croker*, 27 B.T.A. 588 (1933) (Acq.).

[6] *Porter* v. *U.S.* (9 Cir. 1928), 27 F. 2d 882, 6 AFTR 7946. In *Bank of Wyoming*, 22 B.T.A. 1132 (1931) (Acq.), the president of a bank loaned bank funds to various companies in which he was personally interested. Where the loans were made to insolvent companies, the losses were held deductible as embezzlements, but where the companies were solvent the losses were held to be bad debts.

[7] *Austin* v. *Helvering* (U.S.C.A. for D.C. 1935), 77 F. 2d 373, 15 AFTR 1412.

[8] In *James W. Thomas*, par. 53,022 Prentice-Hall Memorandum T.C. (1953), it was held that the taxpayer did not sustain the burden of proving a theft where money which he put in a dresser disappeared after a party. In *Kennedy* v. *U.S.* (D.C., R.I. 1952), 109 F. Supp. 509, 34 AFTR 303, the fact that a metal container in which the money was kept was broken into was held to be sufficient to establish a theft.

[9] *Grover Tyler*, 13 T.C. 186 (1949). See *Ungar* v. *Comm.* (2 Cir. 1953), 204 F. 2d 322, 43 AFTR 921, where a wife took her husband's property and ran off with another man while her husband was overseas in the armed service. Under the law of New York, a taking by the wife does not constitute larceny or embezzlement. No deduction was allowed.

[10] *Burnet* v. *Huff*, 288 U.S. 156, 11 AFTR 1386 (1933); *John H. Farish & Co.* v. *Comm.* (8 Cir. 1929), 31 F. 2d 79, 7 AFTR 8540. Also see *Burke Grain Co.*, 39 B.T.A. 334 (1939) (Acq.).

[11] *C. G. Merrill*, par. 48,133 Prentice-Hall Memorandum T.C. (1948); *Park* v. *Comm.* (2 Cir. 1932) 58 F. 2d 965, 11 AFTR 344, cert. den. 287 U.S. 645; *B. Estes Vaughan*, 17 B.T.A. 620 (1929).

[12] *Harold Guyon Trimble*, par. 64,795 Prentice-Hall Memorandum T.C. (1944). Taxpayer permitted his co-trustee to use trust funds for an improper purpose and later made good the loss. No loss deduction allowed.

In one case,[13] the president of a corporation, who owned about 72 per cent of the common stock and none of the preferred stock, entered bills for fictitious purchases and appropriated for himself considerable funds of the corporation. It was held that the funds were embezzled and that the corporation had a deductible loss. The fraud penalty sought to be imposed against the corporation by the Commissioner was inapplicable because there was no deficiency of tax.

In another case[14] the president, owning 50 per cent of the stock, made large withdrawals without formal authority and charged them to himself on the books. Upon a finding that all stockholders knew of and consented to the withdrawals, it was held that there was no embezzlement.

In the case of *Currier* v. *U.S.*,[15] 75 per cent of the stock was owned by Harold Currier, who was the president and treasurer of the company. The remainder of the stock was owned by his wife who had acquired it by gift from him. Mr. Currier diverted proceeds of sales of corporate merchandise to his personal bank account. No record of the sales was made on the books of the corporation, nor were the amounts included in the income of the corporation. Currier was indicted for making fraudulent corporation tax returns. In defense, it was contended that the returns were not false; that the net income of the corporation was not understated because the funds were embezzled and the corporation was entitled to a deduction equivalent to the understated sales. The Court, without any discussion of the law and without reference to earlier cases, held that the corporation was not entitled to any deduction,[16] and sustained a conviction.

In the case of *J. J. Dix, Inc.*,[17] the president of a corporation who had a life interest in a minority of the stock, his family owning the balance, withheld proceeds of sales. He spent some for the corporation; the balance he used for his own purposes. Here the Tax Court refused to allow any embezzlement loss deduction to the corporation because of lack of proof as to how much was misappropriated.[18]

In both the *Currier* case and the *Dix* case, the officers who diverted corporate funds to their own uses contended that embezzled funds did not constitute income to the embezzler and that they therefore did not thereby individually realize any taxable income. This contention did not prevail in those cases because embezzlements were held not to have been established. The question whether embezzled funds are taxable to the embezzler is unsettled.[19]

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[13] *Summerill Tubing Company*, 36 B.T.A. 347 (1937) (Acq.).

[14] *Franklin Mills*, 28 B.T.A. 218 (1933).

[15] (1 Cir. 1948) 166 F. 2d 346, 36 AFTR 775.

[16] The reasons assigned by the court for refusing to allow the deduction to the corporation in the *Currier* case were (1) part of the money taken was a constructive dividend, (2) the balance, if regarded as borrowed or embezzled, was not deductible because the corporation had a right of action against Currier, and (3) if the amounts were to be considered as a return of capital there would be no basis for a deduction.

[17] Par. 53,174 Prentice-Hall Memorandum T.C., 12 T.C.M. 536 (1953).

[18] The technical reason assigned by the court for refusing to allow the deduction seems to be of questionable soundness. If the amounts taken by the president for his own uses were deductible and if the amounts which he spent for the corporation were deductible, it should not be material whether the specific amounts for each purpose could be identified so long as the total was established.

4. Year of Deduction

Prior to enactment of the Internal Revenue Code of 1954, the regulations[20] and a long line of cases[21] seemed to have established the general rule to be that losses from theft or embezzlement were deductible in the year of occurrence, and not in any subsequent year of discovery.

The application of this rule was harsh, and worked a hardship in many cases. Embezzlements are usually attended with concealment, often sufficiently ingenious to hide the facts for many years. Upon discovery, adjustment of the taxes for some of the years in which the funds were misappropriated is often barred by the statute of limitations. Sometimes the taxpayer could establish the total amount of the loss, but could not prove how much was taken in each year. Thus many taxpayers were denied deductions for proven losses.

In some cases the courts relaxed the rule. In *Boston Consolidated Gas Co.* v. *Comm.*[22] and in *Gwinn Bros. & Co.*,[23] where it was impossible to determine the actual dates of embezzlement, the deduction for the loss was allowed in the year of discovery. In *Samuel M. Felton*,[24] losses sustained by reason of embezzlement by an attorney, to whom funds had been entrusted for investment, were allowed in the year the attorney disappeared and was adjudicated a bankrupt.

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[19] The conflict existing in the earlier decisions was considered to have been settled when the Supreme Court held, in the case of *Comm.* v. *Wilcox*, 327 U.S. 404, 32 AFTR 811 (1946), that embezzled funds are not income to the embezzler by reason of a definite, unconditional obligation to repay and the absence of a bona fide legal or equitable claim to the gain. Subsequently, in *Akers* v. *Scofield* (5 Cir. 1948), 167 F. 2d 718, 36 AFTR 981, cert. den., 335 U.S. 823, money obtained by swindling was held to be income because title to the money passed to the swindler, thus distinguishing the *Wilcox* case. Later, in *Rutkin* v. *U.S.*, 343 U.S. 130, 41 AFTR 596 (1952), the Supreme Court held that money obtained by extortion is taxable income to the extortioner, stating that the *Wilcox* case should be limited to its facts. See *Henry C. Boucher*, 18 T.C. 710 (1952) and *W. L. Kann*, 18 T.C. 1032 (1952).

[20] Reg. 118, § 39.43-2 states ". . . A loss from theft or embezzlement occurring in one year and discovered in another year is ordinarily deductible for the year in which sustained."

[21] *Borden* v. *Comm.* (2 Cir. 1939), 101 F. 2d 44, 22 AFTR 418; *First National Bank of Sharon, Pa.* v. *Heiner* (3 Cir. 1933), 66 F. 2d 925, 12 AFTR 614; *Rahr Malting Co.* v. *U.S.* (D.C., E.D. Wis. 1944), 54 F. Supp. 282, 32 AFTR 595, aff'd on other issues (7 Cir. 1944) 145 F. 2d 867, 33 AFTR 138; *Ralph Murphy*, par. 48,009 Prentice-Hall Memorandum T.C. (1948); *C. T. Haskell*, par. 44,062 Prentice-Hall Memorandum T.C. (1944); *Hendrick Ranch Royalties*, par. 43,137 Prentice-Hall Memorandum T.C. (1943); *Maria G. Miglietta*, par. 43,045 Prentice-Hall Memorandum T.C. (1943); *The Morris Plan Co. of St. Joseph, supra*, note 4; *Burke Grain Co., supra*, note 10; *Alabama Mineral Land Company*, 28 B.T.A. 586 (1933) (Acq.); *Gottlieb Realty Company*, 28 B.T.A. 418 (1933) (Acq.); *Piggly Wiggly Corporation*, 28 B.T.A. 412 (1933) (Acq.); *Douglas County Light & Water Co.*, 14 B.T.A. 1052 (1929); *Southern School-Book Depository, Inc.*, 10 B.T.A. 930 (1928); *J. A. Bentley*, 5 B.T.A. 314 (1926) (Acq.).

[22] (1 Cir. 1942) 128 F. 2d 473, 29 AFTR 531. See *Glenn* v. *Louisville Trust Co.* (6 Cir. 1942), 124 F. 2d 418, 28 AFTR 781, where an unauthorized investment by an agent in 1930, discovered in 1931 and adjusted and settled in 1933, was "viewing the problem realistically" a deductible loss in 1933.

[23] 7 T.C. 320 (1946) (Acq.).

[24] 5 T.C. 256 (1945) (Acq.). In *Lucy D. Gilpin*, par. 47,085 Prentice-Hall Memorandum T.C. (1947), another victim of the same attorney sought to deduct her loss in a later year on the ground that recourse to hidden assets and possible claims against others had not been exhausted in the year of the attorney's disappearance and that the amount of the loss was not ascertained until the later year. The Tax Court held the loss occurred in the year of discovery and not the later year.

The problem reached the Supreme Court in 1952 when two cases with divergent conclusions were reviewed in *Allison* v. *U.S.*[25] In one case,[26] where the identity of the embezzler and the time of embezzlement were unknown, a District Court had permitted the deduction in the year of discovery, relying on the *Boston Consolidated Gas Co.* decision. In the other case,[27] heard in another District Court, the identity of the thief and the precise amounts stolen each year were established, but most of the years were closed by the statute of limitations. Here the District Court had felt bound to follow the general rule[28] and refused to allow the deduction in the year of discovery, although it expressed its sympathy with the position of the taxpayer.

The Supreme Court decided that the general rule was not inflexible and that the year of deduction was a question of fact, not of law, indicating that under special factual circumstances the deduction could be allowed in the year of discovery. This decision left the question wide open, although the inference was that where the year of embezzlement was not known or was closed by the statute of limitations, the deduction could be allowed in the year of discovery.

Section 165 of the Internal Revenue Code of 1954, which in other respects restates the provisions of the 1939 Internal Revenue Code regarding uncompensated losses, introduced a provision intended to settle all uncertainty regarding the year in which theft losses are deductible. Sub-section (e) provides that any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

5. Embezzlement Loss Distinguished from Bad Debt

Prior to the Revenue Act of 1942, the revenue statutes allowed a deduction for "debts ascertained to be worthless and charged off within the taxable year." Since the Revenue Act of 1942, the deduction is allowed in the year of actual worthlessness. These bad debt provisions appear in the revenue statutes concurrently with the provisions permitting deductions for uncompensated losses.

The Supreme Court, in *Spring City Foundry Co.* v. *Comm.*,[29] held the two provisions to be mutually exclusive, and that loss arising from uncollectibility of an account receivable may give rise to a deduction under the bad debt provisions, but not under the uncompensated loss provisions. It has not yet passed on the converse factual situation whether a theft may create a debt so that deductibility of the resulting loss must be governed by the bad debt provisions.

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[25] 344 U.S. 167, 42 AFTR 600 (1952). Prior to this case the status of the law regarding the year of deductibility might have been considered to be unsettled. See Stuetzer, Herman, Jr., "Embezzlement Losses: Time for Deduction," *Tax Law Review*, January 1949. Vol. 4, page 195. The *Alison* case established that the problem was not one of law, but of fact to be decided by the court of original jurisdiction. This was not a satisfactory solution for tax practitioners because the year of deductibility could not be predicted with certainty where it was a question of fact to be found from various attending circumstances. But it would have the effect of relieving appellate courts of the necessity of choosing between conflicting views or reconciling divergent decisions.

[26] *Stevenson-Chislett, Inc.* v. *U.S.* (D.C., W.D. Pa. 1951), 98 F. Supp. 252, 40 AFTR 1070.

[27] *Alison* v. *U.S.* (D.C., W.D. Pa. 1951), 97 F. Supp. 959, 40 AFTR 919.

[28] *Supra*, note 21.

[29] 292 U.S. 182, 13 AFTR 1193 (1934).

If a thief becomes indebted to his victim so as to create a debt within the meaning of the bad debt provision of the revenue laws, then the deduction would be postponed to the year of ascertainment of worthlessness (if prior to 1942), or actual worthlessness of the debt (if after 1942) and the year of deductibility would not necessarily be the year in which the theft occurred or the year in which the theft was discovered.

The question was considered in a number of cases where it was concluded that such obligation or liability as may have been created by the theft did not have the characteristics of the type of debt which came within the bad debt provisions of the Revenue Laws. The question might be deemed to be well settled were it not for recurrent attacks on the proposition.

In *First National Bank of Sharon, Pa.* v. *Heiner*,[30] the Court of Appeals for the Third Circuit concluded that the type of debt intended to be embraced by the bad debt provisions was that created by "contract between a debtor and creditor" or "a sum of money due by certain and express agreement." The Tax Court has likewise held that the mere fact of theft or embezzlement does not create such relationship of debtor and creditor as to defer the deductibility beyond the year of the occurrence.[31]

The decisions holding that embezzlement losses are deductible in the year of embezzlement[32] are based on the supposition that no debt was thereby created within the intendment of the bad debt provisions. Otherwise, such losses would not be deductible until the debt either was ascertained to be, or in fact became, worthless.

Despite the many cases in which it has been held that theft or embezzlement does not create a debt, there have been expressions to the contrary in the opinions of some courts. Circuit Judge Magruder wrote a concurring opinion in the *Boston Consolidated Gas Co.* case, in which he stated that since an embezzler incurs an equivalent debt as surely as if he had borrowed the money and hence has realized no taxable gain, it follows logically that the person whose money is taken does not at that time sustain a loss. In the *Wilcox* case[33] the Supreme Court held that an embezzler is under a definite, unconditional obligation to repay or return the funds or property wrongfully taken: The Tax Court in the *Gwinn Bros. & Co.* case said that it seems clear that the embezzlement made the embezzler debtor to his victim, citing the *Wilcox* case and Judge Magruder's opinion.

In the light of these views, there exists some uncertainty as to the soundness of the long-established proposition that the mere fact of embezzlement does not create a debt within the meaning of the bad debt provisions of the Code, but it would seem that the prevailing view is correct. Otherwise, there could be no deduction for embezzlement; the Code provisions for deductions arising from theft would be meaningless.

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[30] *Supra*, note 21.

[31] *Katherine J. Hanes*, 2 T.C. 213 (1943); *The Morris Plan Co. of St. Joseph, supra*, note 4; *Grenada Bank*, 32 B.T.A. 1290 (1935); *Gottlieb Realty Co., supra*, note 21; *Peterson Linotyping Co.*, 10 B.T.A. 542 (1928); *Parker Wire Goods Co.*, 8 B.T.A. 448 (1927) (Acq.).

[32] See cases cited in footnote 21.

[33] *Supra*, note 19.

Whether or not the original embezzlement creates a debt, the conduct of the taxpayer and the embezzler after discovery of the theft might affect the character of the deduction of the ultimate loss. Settlement with the embezzler and acceptance of his note has been held to amount to a confirmation or ratification of his acts so that deduction of the loss was postponed until the year in which the note became uncollectible.[34]

Section 165(e) of the Revenue Code of 1954 should not only settle such uncertainty as existed regarding the year in which embezzlement losses may be deducted, but it should also dispose of the problem whether an embezzlement creates a debt postponing any deduction until the debt becomes worthless. In disposing of the unjust and harsh result, which often obtained where the taxpayer lost the deduction entirely because he could not prove the dates of the embezzlement or because of barred years, the new provisions eliminate a situation which repeatedly moved taxpayers to contend that embezzlement created a debt postponing deduction until after discovery.

The new provision of the Code probably has no effect on the situation where the victim condones the embezzlement. Thus, where, after discovery, the victim accepts the notes of the embezzler who is not without some means, determination of loss should await collectibility of the notes. In such a case there would be no loss deductible under Section 165(e). The loss, if any, would be governed by the bad debt provisions of the Code.

6. Pursuit of Embezzler and Recoveries

It has been held by the Court of Appeals for the Second Circuit, that the taxpayer is not required to show that he cannot recover from the embezzler in order to sustain the right to deduct amounts embezzled.[35] The Tax Court, in more recent cases, states the rule to be that where there is reasonable ground for expecting reimbursement, the taxpayer must seek redress and may not secure a loss deduction until he establishes that no recovery may be had from the embezzler. If there is no reasonable ground to expect reimbursement, the loss is allowable, even though recovery may be had in a later year.[36]

The taxpayer may be concerned with the amount of the deduction which will be allowed. Unless he is diligent in reducing the loss which he has sustained, he may be denied full deduction. Failure to pursue recovery may reduce the amount of allowable deductions to the extent that recovery was clearly available.[37] Abandonment of the right to recover from the embezzler will defeat deduction for the loss.[38]

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[34] *Douglas County Light & Water Co.* v. *Comm.*, *supra*, note 21, where an embezzlement was discovered in 1916 and note in settlement was obtained in 1921; embezzler went into bankruptcy in 1922, and bad debt deduction was allowed for 1922.

John H. Farish & Co., *supra*, note 10, and *Ledger Co., Inc.* v. *U.S.* (Ct. Cls. 1930), 37 F. 2d 775, 8 AFTR 10030. In *Grenada Bank*, 32 B.T.A. 1290 (1935), where the taxpayer sought to treat an embezzlement loss as a bad debt the Board of Tax Appeals pointed out that there was no note or other promise to repay, nor any charge set up against the embezzler on the books, thereby distinguishing the case from the *Douglas* case and the *Ledger* case. See *Ralph Murphy*, par. 48,009 Prentice-Hall Memorandum T.C. (1948).

[35] *Earle* v. *Comm.* (2 Cir. 1934), 72 F. 2d 366, 14 AFTR 453. The embezzler in this case was the taxpayer's son and it did not appear that any effort was made to recover the loss from him.

[36] *Charles D. Whitney*, 13 T.C. 897 (1949); *George M. Still, Inc.*, 19 T.C. 1072 (1953).

Where amounts which were lost through embezzlement were deducted from income and recovered in a later year, the amount recovered is income in the year of recovery.[39] But, where the year of embezzlement was open, subsequent recoveries have been applied to reduce the deductible loss.[40]

7. Effect of Insurance

Where the loss is covered by insurance, it appears that the general rule regarding the year of deductibility of the loss is modified. If there is a reasonable prospect of recovery, the deduction awaits final determination of the claim against the insurance company, and is allowable in that year.[41] In the case of a solvent insurance company or bonding company, where there is full coverage but the amount of the loss is in dispute and the adjustment is not completed promptly, the taxpayer is justified in withholding any loss deduction until completion of settlement or litigation. The mere fact that the taxpayer is ultimately unsuccessful in his efforts to enforce his claim against the insurance company will not defeat postponement of the deduction.[42]

On the other hand, in the unusual case where the prospect of recovery against the insurer is remote, the deduction is not postponed until termination of litigation or settlement with the insurer.[43]

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[37] *Messenger Corporation* v. *Smith* (7 Cir. 1943), 136 F. 2d 172, 31 AFTR 115. Taxpayer failed to file a claim against the bankrupt embezzler and therefore did not receive the dividend paid to other creditors. The deduction allowed was reduced by the amount which the taxpayer would have received had it filed a claim.

[38] *Vesta Peak Maxwell*, par. 40,081 Prentice-Hall Memorandum B.T.A. (1940).

[39] *South Dakota Concrete Products Co.*, 26 B.T.A. 1429 (1932).

[40] *Samuel M. Felton, supra*, note 24; *Grenada Bank, supra*, note 31; *Schwabacher Hardware Co.*, 45 B.T.A. 699 (1941); *W. S. Phillips*, 24 B.T.A. 98 (1931) (Non-Acq.). In *Max Kurtz*, 8 B.T.A. 679 (1927) (Acq.), where the loss was caused by fire the amount of the deduction was reduced by insurance recovery in a later year.

[41] In *Rose Licht*, 37 B.T.A. 1096 (1938) (Non-Acq.), a fire loss occurred in 1931. The insurance company denied liability and settlement of the claim was made in 1933. The deduction was allowed for 1933. Also see *Bernard Schulenklopper*, par. 47,203 Prentice-Hall Memorandum T.C. (1947); *Piedmont Grocery Co.* v. *U.S.* (Ct. Clms. 1928), 66 Ct. Cls. 468, 7 AFTR 8887, cert. den. 280 U.S. 554. In *Broderick* v. *Anderson* (D.C., S.D. N.Y. 1938), 23 F. Supp. 488, 21 AFTR 472, a 1929 embezzlement, covered by insurance, was discovered in the same year. Time to file claim with the insurer expired in January, 1930. Taxpayer did not file claim within the required period and hence failed to recover. It was held that "not compensated by insurance" means "not covered by insurance"; that the taxpayer was covered by insurance during 1929, and therefore the loss was not deductible until 1930. In *Cahn* v. *Comm., infra*, the Ninth Circuit Court of Appeals disagreed with the Commissioner's argument that "not compensated" means "not covered."

[42] In *The Allied Furriers Corporation*, 24 B.T.A. 457 (1931) (Non-Acq.), the taxpayer sued the insurance company for loss sustained by burglary in 1925. The suit was decided against the taxpayer in 1928, and the deduction was allowed for that later year.

[43] In *Cahn* v. *Comm.* (9 Cir. 1937), 92 F. 2d 674, 20 AFTR 299, Lloyds of London denied liability for a burglary loss which occurred in 1924. The taxpayer was advised by its attorney that the prospect of recovery was not sufficient to justify pursuit. However, suit was instituted and a settlement made in 1925. The Circuit Court of Appeals held that the possibility of recovery was too remote to require any reduction of the amount deductible in 1924, and reversed the decision of the Board of Tax Appeals which had held that the 1924 deduction should be reduced by the amount received in the 1925 settlement.

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How to Treat Involuntary Conversions

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1. Points to Consider

A fire guts a factory; a state authority condemns a blockfront along a proposed route of a thruway; an office machine is stolen. When you weigh the tax consequences of these and similar events, the course of your action will first be determined by the answer to this question: Do the proceeds from insurance or other sources result in a

Gain? If so, was the conversion into:

1. *Similar or related property?* When a conversion is made directly into similar or related property, you have no choice but to postpone the recognition of gain. This is made mandatory by Section 1033.[1] However, in this situation, consider these points:

	Section
Do you have an involuntary conversion?	3
What is similar or related property?	6

2. *Or into money or dissimilar or unrelated property?* When a conversion is made into money or dissimilar or unrelated property, you have an election to come within the non-recognition-of-gain provisions of Section 1033 or to report the gain. But before these tax advantages can be weighed, your replacement plans must be determined. If no replacement is contemplated, then gain must be reported. If a replacement has been planned or if one has been made already, you should consider these points:

	Section
Do you have an involuntary conversion?	3
What to do if the conversion results in a gain	4
When do you have to make a replacement?	5
What is similar or related property?	6
Replacement by acquiring a corporation owning similar property	7

Or Loss? And if so, is it deductible? And if deductible, how can its entire amount be secured? This problem of tax timing the sale of other assets is discussed in Section 8 of this chapter. It is important to observe at this point that Section 1033 applies only to conversions in which gain has been realized. Losses from involuntary conversions are recognized or not recognized without regard to Section 1033.[2]

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[1] 1954 IRC § 1033(a)(1); Reg. 118 § 39.112(f)-1(b).

2. Involuntary Conversions and the Revisions of 1951 and 1954

Section 1033, in its present form, was shaped by a major revision in 1951. This explains the substantive distinction between conversions occurring before January 1, 1951 and those afterwards.

The 1951 amendments alleviated several inequities which characterized the pre-1951 law.[3] Outstanding among these were the two rules that to postpone gain: (1) you had to trace directly the proceeds into the replacement property, and (2) you could not make anticipatory replacements. These restrictions are now limited to conversions which occurred before January 1, 1951.[4] Under the present rule, where a conversion occurs on or after that date, anticipatory replacements can qualify under Section 1033 [5] and the conversion proceeds do not have to be traced into the replacement property.

The 1954 revision, in making the following three amendments, left the 1951 revision substantially intact:

1. Destruction or sale or exchange of livestock by or on account of disease can be treated as an involuntary conversion.[6]
2. Sale or disposal of property within an irrigation project can be treated as an involuntary conversion if made in order to conform to the acreage limitation rules of the Federal reclamation laws.[7]
3. An involuntary conversion of a taxpayer's principal residence occurring after January 1, 1954 is within the scope of Section 1033.[8] This restores the pre-1951 rule. Conversions which occurred between January 1, 1951 and December 31, 1953 were treated as if a sale or exchange had been transacted under Section 112(n) of the 1939 Code (now Section 1034). The principal advantage of this change is that the replacement period can now be extended with the Commissioner's consent, whereas under the latter section, extensions are not provided for.

3. Do You Have an Involuntary Conversion?

You have an involuntary conversion within the rules of Section 1033 when your property,

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[2] Reg. 118 § 39.112(f)-1(a). Before the 1951 amendment, Section 112(f) stated specifically that losses from involuntary conversions were recognized. The amendment eliminated this phrase. However, the House Committee Report (on Public Law 251, 82nd Congress) stated "under existing law and under the bill, loss upon involuntary conversions is recognized."

[3] House Committee Report on Public Law 251, 82nd Congress.

[4] 1954 IRC § 1033(a)(2). The problems arising in pre-1951 involuntary conversions are not covered by this chapter. They are adequately detailed by Leo H. Hoffman in the 1951 edition of the Handbook of Tax Techniques.

[5] 1954 IRC § 1033(a)(3)(A)(i). An anticipatory replacement can qualify as long as it was held at the time of the disposition of the converted property.

[6] 1954 IRC § 1033(e). Before the 1954 revision, the following conversions were allowed under § 112(f) of the 1939 Code: State confiscation of livestock because of disease, I.T. 3554, 1942-1 C.B. 108; Sale of livestock poisoned by contaminated feed pellets, Rev. Rul. 54-395, I.R.B. 1954-38, 7.

[7] 1954 IRC § 1033(d).

[8] 1954 IRC § 1033(b).

1. as a result of being:[9] (a) destroyed in whole or in part, or (b) stolen, or (c) seized, requisitioned, or condemned, or (d) disposed of under a threat or imminence of seizure, requisition, or condemnation,
2. is compulsorily or involuntarily converted into: (a) property similar or related in service or use, or (b) money or dissimilar or unrelated property—and you buy other property similar or related in service or use or stock giving control of a corporation owning such property similar or related in service or use.

Casualties which have caused involuntary conversions can be noted from the following checklist:

Avalanche
Blizzard
Cave-in
Collision
Cyclone
Disturbances below earth's surface
Drought
Dry wave
Earthquake
Explosion
Extreme cold
Extreme heat
Fire
Flood
Heavy rain
Hurricane
Ice pressure
Landslide
Lightning
Shipwreck
Sinking of land
Storm
Stream or river changing its course
Thaw
Tidal wave
Tornado
Unusual quarry blast
Volcanic eruption
Wet wave

You may also have an involuntary conversion as the result of governmental action, such as:

Eminent domain
Condemnation
Confiscation
Seizure
Appropriation
Expropriation
Forced cessation
Restraining actions
Requisitioning
Changes in riparian rights
Desist production decrees, and the like
Forced relocation

Theft may also be the basis of an involuntary conversion.

When property is converted as result of any of the above causes, you should have little difficulty in proving there is an involuntary conversion within the definition of Section 1033(a). However, where property has been disposed of under the threat or imminence of seizure that never materializes, it may be difficult to prove the "threat or imminence"—especially if the "threat or imminence" arose from less than a formal condemnation proceedings. For example, inadequate conversions were found in the following cases:

1. Sale because of mere complaints, no legal compulsion.[10]
2. Discarded railway or retired roadway properties to make way for new construction projects, cost of which was borne by the States out of funds allotted in whole or in part

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[9] 1954 IRC § 1033(a).

[10] *Piedmont-Mt. Airy Guano Co.*, 8 B.T.A. 72(A) (1927).

by the Federal government from unemployment relief funds. No part paid as compensation for the old property.[11]

3. Sale of stock investment because of business expediency or to prevent ruin.[12]
4. Sale because of threats of creditors.[13]
5. Fact that German bonds purchased in 1926, were in 1933 payable only in blocked marks, which could be reinvested only in other German property or securities or sold on the New York market for such amount as they might bring.[14]
6. Redemption of Federal government bonds before maturity, pursuant to express terms on face thereof.[15]
7. Sale to a new industry because of insistent request of local chamber of commerce.[16]
8. Sale of stock of Corporation "A" by "B" after his removal from office because stock contained the condition that it could not be held by anyone other than an officer or director, except with the consent of the board of directors.[17]
9. Patent infringement.[18]
10. Sale of stock of a Brazilian corporation on passage of legislation justifying a fear of nationalization of the corporation.[19]

4. What to Do if an Involuntary Conversion Results in a Gain

Under Section 1033, where money or dissimilar property is received as a result of a conversion, there can be no non-recognition of gain unless similar or related property is acquired. Therefore, your tax alternatives depend upon your replacement plans.

Where you do not intend to make a replacement, you have no choice but to report the gain in the year it is realized.[20] However, where a replacement is planned (or where one has already been made), a decision to come within non-recognition-of-gain provisions of Section 1033 is first determined by the amount of the investment to be made (or made) in the new property. For example, when the cost of the replacement is:

1. Equal to or less than the adjusted basis of the converted property, the entire gain[21] must be reported.

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[11] G.C.M. 21171, 1939-1 C.B. 169.

[12] G. A. *Robins*, 15 B.T.A. 1068 (1929).

[13] *P. F. Tirrill*, 14 B.T.A. 1399 (1929).

[14] *Credit & Investment Corp.*, 47 B.T.A. 673 (1942).

[15] I.T. 1354, I-1 C.B. 190.

[16] *Davis Co.*, 6 B.T.A. 281(A) (1927).

[17] I.T. 2247, VI-2 C.B. 19.

[18] *Nicholas W. Mathey*, 10 T.C. 1099 (1948).

[19] *Edmond Weil, Inc.* v. *Commissioner* (2 Cir. 1945), 150 F. 2d 950, 34 AFTR 121, affirming Tax Court Memo Dec.

[20] The gain is reported in the return for the taxable year or years which any of such gain is realized. In the same return, you should file a statement notifying the District Director in the district in which the return is filed of your intention not to replace. Failure to include the gain is treated as an election to come within the non-recognition provisions of the section. See Reg. 118 § 29.112(f)-1(C)(2). It is important to note that recognized involuntary conversion gains of property used in a trade or business and capital assets held for more than six months fall within the rules of Section 1231.

[21] For example, adjusted basis of converted property was $75,000; proceeds received were $100,000 giving rise to $25,000 gain on the conversion. If similar property is purchased for $70,000, the entire gain of $25,000 is reported. Gain from an involuntary conversion is tax free only to the extent that the proceeds are used to purchase replacement property. Therefore, if the whole amount of the proceeds is not so used, gain is taxed to the extent of the unreinvested proceeds.

2. Less than the proceeds (or award) but more than the adjusted basis of the converted property, the difference between the proceeds (or award) and the cost of the replacement must be reported as gain. However, you can elect to report or not to report the balance of the gain.[22]

3. Equal to or more than the proceeds (or award), you can elect to report or not to report the entire gain.[23]

When you can choose between reporting or not reporting the gain, you may find an over-all tax savings by electing to report the gain. By coming within Section 1033, the cost of the replacement property is reduced by the amount of the gain not recognized.[24] In the case of depreciable property, the loss in annual depreciation deductions (from a lower cost basis) may not be offset by the elimination of the tax—a tax which would be limited to capital gain rates if the converted property was held for more than six months before its conversion. However, in the case of a non-depreciable asset, the lower cost basis will effect only a future sale. Hence, an election to come within Section 1033 should be decided by balancing the present tax savings of an election against the possibilities of a future sale and its tax cost. Where a future sale is contemplated, your decision will turn on whether or not a greater tax savings will be had by paying a tax now and taking a stepped-up basis that may help to cut the tax on a future sale.

Where your replacement plans are inchoate at the time gain is realized, you can elect to postpone the tax by not reporting the gain. If you do not follow the election with a replacement, you can file an amended return reporting the gain with the necessary tax adjustments.[25] If you report the gain and you later make a replacement within the time limits discussed in Section 5, you can make an election to come within Section 1033 by filing a refund claim for the tax attributed to the reported gain.[26]

No election is necessary where the conversion was directly into similar or related property. The non-recognition of gain is required in this case.[27]

5. When Does a Replacement Have to Be Made?

The period during which you can make a replacement is limited. The replacement period [28]

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[22] Using the same figures as in footnote 21 except that the replacement cost is $85,000. Reported gain is $15,000 ($100,000-85,000). And an election to report the $10,000 balance or to eliminate the tax on this amount is available. Tax would be eliminated on the $10,000 by not reporting the amount in the tax return for taxable year in which it is realized. See Reg. 118 § 39.112(f)-1(c)(2).

[23] Using the same figures as in footnote 22 above except that the replacement cost is $100,000. The entire gain of $25,000 is not recognized if an election is made to come within § 1033. An election is made by not reporting the gain in the tax return for the year in which it is realized. See Reg. 118 § 39.112(f)-1(c)(2).

[24] 1954 IRC § 1033(c). Basis of purchased replacement property for a conversion which occurred after 1950 is its cost reduced by amount of gain not recognized. Where more than one piece of property has been acquired, the basis is allocated in proportion to their respective costs.

[25] Reg. 118 § 39.112(f)-1(c)(2).

[26] Footnote 25 above.

[27] Footnote 1 above.

[28] 1954 IRC § 1033(a)(3)(B).

1. *begins* with the date of the disposition of the property, or with the date of the beginning of the threat or imminence of requisition or condemnation of the property, whichever is the earlier, and
2. *ends* one year after the close of the first taxable year in which any part of the gain on the conversion is realized.

If you can show a reasonable cause for not replacing the converted property within the required time limits, you may get an extension of time.[29] The application for an extension should be made to the District Director for the district in which the return is filed for the first taxable year in which any of the gain was realized.[30] When a replacement is finally made, the District Director should also be notified of its details in the tax return for the taxable year in which the replacement is acquired.[31]

The filing of this notice is necessary to start the running of the period of limitations for the assessment of any deficiency attributable to the gain. Failure to give notice will keep the statutory period open.[32] Similarly, a failure to give notice of an intention not to replace will have the same result.[33] Where a replacement is not made after an election, an amended return should also be filed with the necessary tax adjustments for the year in which the gain was realized.[34]

6. What Is Similar or Related Property?

To come within the non-recognition provisions of Section 1033, the replacement property must be similar or related in service or use to the property converted.[35] The problem of what is property similar or related in service or use has been the subject of much litigation. The issue is one of fact that can best be answered by what the courts have considered to pass as proper replacements and those which have not, as is shown in the following list.

Gain not recognized
(Investment in similar or related property)

1. Proceeds of condemnation of unimproved realty invested in unimproved realty.[36]
2. Proceeds of a sunk steamship used to buy a steamship of the same general type but of greater dead-weight tonnage, so far as it equals the tonnage of the original vessel.[37]
3. Two sheds, east and west, used as a single unit for the storage of baled cotton and connected by a passageway; west shed was completely destroyed by fire and the east partially so destroyed; insurance proceeds were used to reconstruct and enlarge east shed so

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[29] 1954 IRC § 1033(a)(3)(B)(ii).

[30] The application should be made before the end of the one year after the close of the first taxable year in which any part of the gain is realized. See Reg. 118 § 39.112(f)-1(c)(3).

[31] Reg. 118 § 39.112(f)-1(c)(5).

[32] Where an election is made to come within the non-recognition provisions of Section 1033, the statutory period for the assessment of a deficiency (for any tax year in which any part of gain is realized) attributable to the gain does not expire before the end of 3 years from the date the District Director is notified of a replacement or of an intention to replace. See Section 1033(a)(3)(C)(i).

[33] *Ibid.*

[34] Reg. 118 § 39.112(f)-1(c)(2).

[35] 1954 IRC § 1033(a)(3).

[36] I.T. 1617, II-1 C.B. 119.

[37] T.B.M. 61, 1 C.B. 76 (Article 49 of Reg. 45 controlling).

that it had a capacity slightly more than the combined equal capacity of the two old sheds.[38]

4. Proceeds from conversion of factory equipment used to buy new equipment of the same type but with a slightly larger capacity.[39]

5. Stock of a liquidated corporation converted into stock in another corporation engaged in like activities.[40]

6. Proceeds from leasehold used to construct a building on taxpayer's land; moved old machinery and equipment therein, and conducted therein the same manufacturing business.[41]

7. Building acquired, like the one converted, was a business property; but income of new was from ground floor stores, whereas, income of old was from ground floor stores and the operation of a motion picture theatre. There were differences in the type of construction and the height and depth of buildings.[42]

8. Condemnation award for farm land used for growing crops spent to buy land used for raising livestock or growing fruit.[43]

9. Fire insurance proceeds used to build a much more modern plant with 25% greater capacity.[44]

10. Condemnation award on improved realty used to purchase vacant lots and build improvements thereon; or to improve vacant land previously owned.[45]

Gain recognized
(*Investment not in similar or related property*)

1. Proceeds of *unimproved* real estate, taken upon condemnation proceedings, are invested in improved real estate.[46]

2. Proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold.[46]

3. The owner of a requisitioned tug uses proceeds to buy barges.[46]

4. Fire Insurance proceeds received on destruction of rental property used to build addition to bank.[47]

5. Fire insurance proceeds used to pay off a note to the bank subsequently financing construction of replacement building, as a condition to its participation in this subsequent financing.[48]

6. Proceeds from condemnation of leased factory building, received by factory tenant who had installed machinery and equipment therein, invested in machinery and equipment.[49]

7. Condemnation award used to reduce mortgage indebtedness on a piece of similar property acquired before the award.[50]

8. Condemnation award on improved realty used to acquire a mortgage.[51]

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[38] *Cotton Concentration Co.*, 4 B.T.A. 121 (A) (1926).

[39] *Davis Co.*, 6 B.T.A. 281 (A) (1927).

[40] *Edmond Weil, Inc.* v. *Commissioner* (2 Cir. 1945), 150 F. 2d 950, 34 AFTR 121, affirming Tax Court Memorandum decision.

[41] *Davis Regulator Co.*, 36 B.T.A. 437 (A) (1937).

[42] *M. J. Caldbeck Corp.*, 36 B.T.A. 452 (1937).

[43] House Committee Report on Public Law 251, 82nd Congress.

[44] *Hocking Glass Co.* v. *Miller*, 5 F. Supp. 355, 13 AFTR 127, reversed on another issue (6 Cir. 1935) 80 F. 2d 436, 16 AFTR 1448, cert. den. 298 U.S. 659 (1936).

[45] *Winter Realty & Construction Co.*, 2 T.C. 38 (1943-44), affirmed on this issue (2 Cir. 1945), 149 F. 2d 574, 33 AFTR 1411.

[46] Reg. 118 § 39.112(f)-1(9).

[47] *Lynchburg National Bank and Trust Co.* (4 Cir. 1954), 208 Fed. (2d) 757.

[48] *Continental Realty Co.*, T.C. Memo, Dkt. 80, January 14, 1944, par. 44,010 Prentice-Hall Memorandum T.C.

[49] I.T. 3793, 1946-1 C.B. 96.

[50] I.T. 2700, XII-2 C.B. 73.

[51] *Twinboro Corp.*, par. 43,318 Prentice-Hall Memorandum T.C. (1943) affirmed (2 Cir. 1945) 149 F. 2d 574; *Winter Realty & Construction Co.*, 2 T.C. 38 (1943-44) Reversed in part, affirmed in part (2 Cir. 1945), 149 F. 2d 567.

9. Condemnation award on improved realty used to pay benefit assessments on land previously owned and properly improved under 112(f) of 1939 Code.[52]
10. Assumption of a mortgage on similar property, without payment thereof.[53]

7. Replacement by Acquiring a Corporation Owning Similar Property

Conversion proceeds can be used to acquire control of a corporation owning property similar or related in service or use to the property converted.[54] The control test is probably met if you acquire at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of the corporation.[55] Nothing short of actual ownership will suffice; family relationship, or any other type of control is not ownership.[56] Subsequent liquidation of the acquired corporation does not make the conversion gain taxable.[57]

The following list gives you an indication of what the courts have considered to be related and unrelated corporate acquisitions.

Related Acquisitions

Proceeds of fire insurance on lumber mill and yards used to purchase all of capital stock of a lumber company having similar assets.[57]

Consolidation of corporation suffering fire loss with another under Missouri law, and consolidated company buying replacement machinery.[58]

Condemnation award used to buy all stock of corporation owning suitable real estate.[59]

Proceeds of fire insurance used to acquire direct ownership of stock of corporation, even though control of a practical nature, such as family relationship existed at time of fire.[60]

Unrelated Acquisitions

Four individuals (brothers) owned stock of Vim Securities and Vim Electric. Vim Securities owned a warehouse of which Vim Electric was tenant. The warehouse was condemned. The brothers created Gold Street Corp., also equally owned by them, to acquire another warehouse.[61]

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[52] *Winter Realty & Construction Co.*, footnote 51 above, affirmed on this issue.

[53] *Twinboro Corp*, footnote 51 above.

[54] 1954 IRC § 1033(a)(3)(A).

[55] Under 1939 Code Section 112(h) defined control as meaning the "ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of total number of shares of all other classes of stock of the corporation." The definition specifically applied to Section 112(f). In 1954 Code, this definition was placed in Section 368(c) as defining control in Subchapter C which covers corporate distribution and adjustments. However, no reference is made to Section 1033. But inasmuch as this aspect of Section 112(f) of the 1939 Code was incorporated into the 1954 Code without any substantive change, it is assumed that the 1939 Code definition of control applies here too.

[56] *Kimball-Diamond Milling Co.*, 10 T.C. 7(A) (1948).

[57] *Kennebec Box & Lumber Co.* (1 Cir. 1948), 168 F. 2d 646, 36 AFTR 1099.

[58] *Excelsior-Leader Laundry Co.* 8 B.T.A. 183 (1927), (14), Revenue Act of 1921.

[59] *Henderson Overland Co.*, 4 B.T.A. 1088 (1926).

[60] Footnote 56 above.

[61] *Vim Securities Corp.* v. *Commissioner* (2 Cir. 1942), 130 F. 2d 106, *cert. den.* 317 U.S. 686, affirmed 43 B.T.A. 759 (1941).

8. What Happens When an Involuntary Conversion Results in a Loss?

The deduction of an involuntary conversion loss does not depend upon the purchase of replacement property but upon the general rules governing the deduction of losses. That is, conversion losses incurred in a trade or business or in a transaction entered into for profit, though not connected with a trade or business, can be deducted. However, in the case of losses sustained by an individual, if they cannot be fitted into the previously mentioned categories, they are not deductible unless they qualify as casualty or theft losses.[62] For example, a loss of a personal residence by fire is deductible, but not a loss resulting from a sale of a residence under the threat of eminent domain proceedings.

A major problem created by involuntary conversion losses is their effect, under Section 1231 (formerly Section 117(j) of the 1939 Code), on the treatment of gains and losses from sales of property used in a trade or business and held for more than six months. By its provisions, before long-term capital gain treatment can be extended to such sales at a profit, recognized gains from these sales, plus recognized gains from involuntary conversions of property used in a trade or business, and capital assets held for more than six months, must exceed recognized losses from such sales plus losses from involuntary conversions from property used in a trade or business and capital assets held for more than six months. However, if the losses exceed the gains, then capital gain treatment is lost, and the gains and losses are treated separately as sales and exchanges of non-capital assets. Therefore, sales, at a profit, of property used in a trade or business and held for more than six months, must be carefully planned in the year in which an involuntary loss has been sustained. Sale of such property at a profit should be postponed to another taxable year. In this way, you take full advantage of the involuntary conversion loss, and you insure capital gain treatment of the gain, at least, in another taxable year.[63]

9. How to Treat Special Assessments, Severance Damages, and Use and Occupancy Insurance

A condemnation may take only part of a taxpayer's property, and the remaining part may be assessed on the grounds that it is benefited by the improvement which has motivated the partial condemnation. This assessment is treated as reducing the amount of the condemnation award in computing the amount of gain or loss on the condemnation.[64] However, if the condemning authority pays out of the award liens and mortgages against the property, the payment is not deductible from the gross award.[65]

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[62] 1954 IRC § 165(c).

[63] Where gain was realized in the same year as the involuntary conversion loss, and where it exceeded the loss, each transaction would be treated separately as if derived from the sale or exchange of a capital asset held for more than six months. Hence, an ordinary deduction for the loss would be lost. Where the loss exceeded the gain, the ordinary deduction attributable to the loss would be reduced by 100 per cent of the gain which if it was realized alone would be taxed at only capital gain rates. See Section 1231(a).

[64] Reg. 118 § 39.113(f)-1(10); *The Christian Ganahl Co.* v. *Commissioner* (9 Cir. 1937), 91 F. 2d 343, 19 AFTR 1114, cert. den. 302 U.S. 748, 34 B.T.A. 126 (1936) reversed.

[65] *Commissioner* v. *Fortee Properties, Inc.* (2 Cir. 1954), 211 F. 2d 915. This is so even though the seller was not personally liable on the mortgage.

Severance damages are treated as reducing the basis of the remaining property. The excess over the basis is taxed.[66] Where the award includes interest, the interest amount is taxed as interest income, and is not tax exempt.[67] If an award is litigated, interest is taxed in the year in which the judgment becomes final.[68]

Proceeds from use and occupancy insurance are taxed as income where the policy provides for the reimbursement of profits. But if the proceeds are for reimbursement against loss of use and occupancy or "business interruptions" and are on a fixed daily basis without any relation to profits, they are treated as proceeds from an involuntary conversion.[69]

Insurance proceeds from separately insured units destroyed by fire will not be treated as a whole. When a taxpayer realizes gain from certain adjusted units and losses on others, he may reinvest the proceeds from the units upon which there was gain and deduct loss on units he does not replace.[70]

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[66] *Calvin C. Green,* 37 B.T.A. 25 (A) (1938); G.C.M. 12657, XIII-1 C.B. 80; *Jamieson Associates, Inc.,* 37 B.T.A. 92,108 (1938), affirmed *sub nomine, Seaside Improvement Co.* v. *Commissioner* (2 Cir. 1939), 105 F. 2d 990, 23 AFTR 293, cert. den. 308 U.S. 618 (taxpayer failed because proof was inadequate).

[67] *Kieselbach* v. *Commissioner,* 317 U.S. 399 (1943) (3 Cir. 1942), 127 F. 2d 359, 29 AFTR 270, which reversed 44 B.T.A. 279 (1941), affirmed.

[68] *Winter Realty & Construction Co.,* 2 T.C. 38, 55 (1943-44).

[69] Insurance proceeds treated as income: *Miller & Hocking Glass Co.* (6 Cir. 1935), 80 F. 2d 436, 16 AFTR 1448, cert. den. 298 U.S. 659, reversing 5 F. Supp. 355, 13 AFTR 127; *International Boiler Works,* 3 B.T.A. 283 (1926); Reg. 29.112(f)-1. Insurance proceeds treated as from involuntary conversion: *Piedmont-Mt. Airy Guano Co.,* 3 B.T.A. 1009 (1926); *Flaxlinium Insulating Co.,* 5 B.T.A. 676 (1926); *Williams Furniture Corp.,* 45 B.T.A. 928 (1941); *Darlington Veneer Co. Inc.,* 46 B.T.A. 1277 (1942) (par. 42,056 Prentice-Hall Memorandum B.T.A.).

[70] *International Boiler Works,* 3 B.T.A. 283 (A) (1925).

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Life Insurance and Annuities Under the Internal Revenue Code of 1954[1]

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Under the Internal Revenue Code of 1954,[2] life insurance and annuity tax law has a new look. Important tax relief has been granted, loopholes have been plugged, uncertainties have been clarified, and new uncertainties have been created.

Only one prior section, applicable to life insurance and annuities, has been reenacted without substantial change. All sections are renumbered, and several new provisions have been introduced.

Intelligent tax planning necessitates knowing the rules, and the rules of the game have changed. This chapter will summarize and compare the rules of the old with the new tax law as they affect life insurance company contracts.

1. Points to Consider

The following section of the Internal Revenue Code of 1939 has been incorporated into the new law without substantive change:

1939 IRC Section No.	*1954 IRC Section No.*	*Section Description*	*Section*
826(c)	2206	Liability of Life Insurance Beneficiaries	13

The following sections of the Internal Revenue Code of 1939 have been revised:

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[1] This article does not include a consideration of employee qualified plans. Reference to Code Sections is to IRC 1954 unless otherwise specifically designated. Hearings and reports of the 83rd Congress, second session, applicable to the new tax law are cited: House Report—H. Rep.; Senate Report—Sen. Rep.; Senate Hearings—Sen. Hr.; Conference Committee Report—Conf. Rep.

[2] The new Code is generally applicable to tax years beginning after 1953 and ending after the date of enactment, August 16, 1954. Those sections considered in this article having other effective dates will be specifically noted.

1939 IRC Section No.	*1954 IRC Section No.*	*Section Description*	*Section*
22(b)(2)	72	Annuities and Certain Proceeds of Endowment and Life Insurance Contracts	3
22(b)(1)	101	Certain Death Benefits	4
24(a)(4)(6)	264	Certain Amounts Paid in connection with Insurance Contracts	5
22(b)(2) and 113(a)(5)	691(d)	Amounts Received by Survivor Annuitant Under Joint and Survivor Annuity Contract	6
811(g)	2042	Proceeds of Life Insurance	11
812 (e)	2056(6)	Life Insurance Annuity Payments with Power of Appointment in Surviving Spouse	12
1003	2503	Taxable Gifts	14

The following section was proposed by HR8300 but eliminated from the Bill as finally enacted:

1954 IRC Section No.	*Section Description*	*Section*
1241 (House)	Exchanges of Property for an Annuity Contract	9

The following sections of the Internal Revenue Code of 1954 contain entirely new provisions or cover matters having no specifically corresponding section under prior law:

1954 IRC Section No.	*Section Description*	*Section*
37	Retirement Income Credit	2
1021	Sale of Annuities	7
1035	Certain Exchanges of Insurance Policies	8
2039	Annuities (Re Estate Tax)	10
	Conclusion	15

2. Retirement Income Credit

SECTION 37 (new provision)

Purpose. To adjust the preferential tax treatment accorded Social Security and certain other federal retirement programs by granting similar treatment to other publicly administered, private pension, and individual programs providing for old age.

New law. This section provides a tax credit up to $240 for each individual against his income tax—if he is eligible. To be eligible for all or part of this tax credit, the taxpayer must:

1. have received earned income of at least $600 in each of any 10 previous calendar years; and
2. have attained the age 65 years before the close of the taxable year, or be under a public retirement system; and

3. have received the qualifying type of retirement income; and
4. be a citizen or resident alien; and
5. have computed the tax credit on his tax return.[3]

In determining whether he is eligible, the taxpayer must understand the definitions of the various terms used, such as retirement income, public retirement system and earned income. "Retirement income" is defined: 1) in the case of an individual who has attained age 65 years before the close of the taxable year, as being income from pensions, annuities, interest, rent and dividends, and 2) in the case of an individual who has not attained the age of 65 years before the close of the taxable year and is under a public retirement system, as being income from *only* pensions and annuities. "Public retirement system" is defined as meaning a pension, annuity, retirement or similar fund or system established by the federal or state government or certain other enumerated political subdivisions thereof.[4] "Earned income" is defined as including wages, salaries, professional fees and other compensation.[5]

Both husband and wife may qualify, and a widow or widower whose spouse has previously received such earned income is to be considered as having received such earned income.[6]

If eligible, the taxpayer is allowed a credit against his income tax in an amount equal to the total qualifying retirement income multiplied by the lowest tax rate, limited by the following:[7]

1. The amount of the qualifying retirement income taken into consideration shall not exceed $1200,
   (a) less any amount received under Social Security or other federal exempt programs,[8] or otherwise excluded from gross income,[9] and
   (b) less any amount of earned income in excess of $900 received by any individual who has not attained the age of 75 before the close of the taxable year;[10]

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[3] Under Section 6014(a), if the taxpayer fails to compute his retirement income credit, no such credit shall be allowed.

[4] Under considerable pressure, the Senate amended the House version, limiting retirement income to individuals who have attained age 65, to include individuals under 65 subject to a Public Retirement System. See Sen. Rep., pp. 748-780. (Accepted by Conf. Rep., pp. 22-23.) Perhaps this preference for government employees is based on the theory that people age quicker when toiling for public wages. Public Law 299, Eighty-Fourth Congress (Chapter 659, First Session), H. R. 291, amended Section 37(f), extending retirement income credit to include members of the Armed Forces, which under the 1954 Code had been specifically excluded.

[5] Earned Income as defined in Section 27(g) has the meaning assigned to such term in Section 911(b) "except that such term does not include any amount received as a pension or annuity." This exception was added by the Senate and approved in Conference to make clear that pensions and annuities are not included in the definition of "earned income."

[6] H. Rep., pp. 8, A16; Sen. Rep., pp. 8,165. In a community property state both husband and wife may qualify on the basis of the earnings of the other since the earnings are considered as being earned one-half by each spouse.

[7] The lowest tax bracket is currently 20 per cent.

[8] Since Social Security and other types of federal programs are already excluded from gross income, this section provides an adjustment to avoid duplication. H. Rep., p. 8; Sen. Rep., p. 8.

[9] H. Rep., p. A17 and Sen. Rep., p. 166, give as an example of programs otherwise excluded from gross income, "certain veteran's pensions exempt from taxes."

[10] If under 75 taxpayer must reduce his retirement income by the amount of any earned income in excess of $900; and if he has earned income of at least $2,100, in the taxable year, he is not entitled to any retirement income credit.

provided that (a) and (b) shall not apply to any amounts excluded from income under Section 72, relating to annuities, Section 101, relating to life insurance proceeds, Section 104, relating to compensation for injuries or sickness, Section 105, relating to amounts received under accident and health plans, Section 402, relating to taxable beneficiary of employees' trust, and Section 403, relating to taxation of employee annuities.[11]

2. The tax credit thus computed shall not exceed the individual's income tax for the taxable year reduced by the tax credits allowable under Section 32(2), relating to tax withheld at the source on tax-free covenant bonds, Section 33, relating to foreign tax credit, Section 34 relating to credit for dividends received by individuals, and Section 35, relating to partially exempt interest,[12] and further cannot reduce the tax below zero.[13]

Comment. An estimate has been made that this provision would decrease revenues by $141,000,000 in the fiscal year 1955 and benefit 1,500,000 taxpayers. This apparently presumes that this number of taxpayers will have the ingenuity to make the complicated computation required. It may very well be that the taxpayer qualified to receive retirement income tax credit will contribute a great portion of such credit for competent professional services.[14]

Because of the complementary nature of Section 37 to Social Security, it may be anticipated that recent changes in the Social Security law will be reflected in corresponding changes in retirement income credit.[15]

The eligibility of individuals who are retired before age 65 under a public retirement system discriminates against other individuals retired before that magic age and not so fortunate as to have been public servants.

3. Annuities and Certain Proceeds of Endowment and Life Insurance Contracts

SECTION 72[16] (formerly Section 22(b)(2))

Purpose. To standardize income tax treatment of proceeds under annuity, endowment and life insurance contracts and to continue taxing interest payments as under prior law.

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[11] Since the amounts received under these Sections are not includable in taxable income, they may not be used to reduce the amount of retirement income. H. Rep., p. A17; Sen. Rep., p. 166.

[12] The Sen. Rep. inserted the reference to Section 32(2). A Senate Floor Amendment eliminated reference to Section 34, but the Conference Committee reinserted it. Conf. Rep., pp. 22-23.

[13] H. Rep., p. A16, and Sen. Rep. p. 165, state that this credit cannot reduce the tax below zero and in the event "the amount of the credit exceeds the tax otherwise due, no taxpayer shall be entitled to a refund by virtue of this section."

[14] For a detailed example computing the retirement income credit see Sen. Rep., p. 167.

[15] Sen. Rep., p. 167, summarizes the present tax benefits of this section as follows: ". . . to allow an unmarried individual (using the standard deduction), with no dependents to receive a maximum amount of $2,666 of retirement income tax free; a married individual with no dependents, but with a wife to whom the Section is inapplicable, a maximum of $4,000; and a married couple, each of whom qualifies and each of whom possesses retirement income, a maximum amount of $5,333."

[16] The effective starting date of this provision is January 1, 1954.

Prior law. There are three basic types of annuity contracts or annuity provisions under life insurance or endowment contracts: (1) life, (2) refund (period certain) and (3) joint and survivor. Payments under all three types are included in gross income in an amount equal to 3 per cent of the net premiums plus any other consideration paid for the annuity until the total net amount paid has been returned tax free. Additional installments received thereafter are fully taxable.[17]

However, in joint and survivor contracts, the survivor's annuity payments are taxed under the 3 per cent rule based upon a new annuity valuation as of the date of death of the joint annuitant, or the value one year after death, if the optional valuation for estate tax purposes is taken.

Payments made for life under an endowment policy are taxed as an annuity. The basis used, however, depends upon the *time* of selection. If request for installment payments based upon life expectancy is made prior to maturity, the net premiums plus any other consideration paid for the contract is subject to the 3 per cent rule. If request for installment payments based upon life expectancy is made at or after maturity, the *maturity* value is subject to the 3 per cent rule.[18]

Where proceeds are taken in a single sum under a life insurance, endowment or annuity contract, the difference between the net premiums plus any other consideration paid and the amount received is subject to ordinary income tax.

When a fixed number of installments (not dependent on recipient's life expectancy) is received, under a life insurance, endowment or annuity contract, all payments are tax free until the net cost has been recovered. Additional installments received thereafter are fully taxable.

New law.[19] The "life-expectancy" rule is substituted for the "3 per cent" rule. Income tax treatment of proceeds of an annuity, endowment, or life insurance contract has been comprehensively revised. Three types of annuity contracts or annuity provisions under life insurance or endowment contracts are considered: (1) life, (2) refund (period certain) and (3) joint and survivor.

This section excludes from gross income that part of the annuity payment which equals the net premiums plus any other consideration paid, divided by the annuitant's life expectancy at the time annuity payments begin.[20] Under this arrangement, an annuitant would receive his total net deposits tax-free if he exactly lives out his life expectancy; but if he lives beyond his life expectancy, the excludable portion of each annuity payment would continue to be the same.[21]

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[17] In 1934 the 3 per cent rule was devised to tax currently an amount which would approximate the interest portion of each annuity payment. The remainder of each payment, representing the return of principal, was exempt until the aggregate of such exempt portions equalled the consideration. The interest factor was arbitrarily set at 3 per cent as an approximate average of the interest rates effective under commercial annuities.

[18] When election of an installment option is made at or after maturity of the endowment contract, the maturity value is considered to have been constructively received.

[19] This Section does not apply to an annuity, endowment or life insurance contract includable in the gross income of wife under Section 71. (Alimony and Separate Maintenance Payments.)

[20] However, with respect to the primary annuitant, of a joint and survivor annuity, who has died after 1950 and before 1954, the former law permitting a stepped up basis is retained. The survivor's investment in the contract is determined under Section 113(a)(5) IRC 1939 less any amounts recovered tax-free before the annuity starting date.

[21] Example: Under old law, prior to maturity of a $10,000 20-Year Endowment Contract, the owner elected to have the proceeds paid as a life annuity of $536.40 a year (20 years certain). Net premiums paid for the contract amounted to $8,500. Each year $255.00 is taxable

An annuitant living beyond his life expectancy, therefore, will recover tax-free more than the amount paid for the annuity.

The basis of an insurance company contract having a refund feature is reduced by the value of any such refund (computed without discount for interest) as of the annuity starting date. In the case of joint and survivor annuity, the cost is to be apportioned over the combined life expectancy of the annuitants. (See discussion under Section 691(d).)

Life annuity. *Example:* A purchases for $50,000 a single premium immediate annuity which will pay him $325 per month during his lifetime. At his death, there are no further payments. At the date of the first annuity payment, A's life expectancy is 15 years. The excluded portion of each $325 payment will be $50,000 divided by 15 (expectancy) divided by 12 (number of months in a year) or $277.59. (Under temporary regulations life expectancy figure is reduced by subtracting .1 if payments are quarterly; .2 if payments are semi-annual; .5 if payments are annual.) The balance of $47.41 will be included in income.

Refund annuity. *Example:* A purchases for $50,000 an immediate installment refund annuity which will pay him $240 per month during his lifetime. At his death, annuity payments will be continued to a beneficiary until the sum of guaranteed payments equals the purchase price. The value of the refund feature must be calculated first. The first step is to divide $50,000 by $2,880 (12 × 240) or 17.36. This is rounded to nearest whole number or 17. Table III of temporary regulation is then used to find percentage for annuitant's age (65) as of annuity starting date and 17 (the number of whole years) or 28%. The value of the refund feature is $14,000 (28 per cent of $50,000). Therefore, the excluded portion of each $240 payment will be $36,000 ($50,000 less $14,000) divided by 15 (expectancy) divided by 12 (number of months in a year) or $200. The balance of $40 will be included in income.

Joint and survivor annuity (uniform payment). *Example:* A purchases for $50,000 an annuity contract which will pay him and his wife $225 per month during their joint lives and during the life of the survivor. At the date of the first annuity payment, their joint life expectancy is 23 years. (See Table II of Temporary Regulation for Sec. 72.) The excluded portion of each $225 payment will be $50,000 divided by 23 (expectancy) divided by 12 (number of months in a year) or $181.16. (See Life Annuity example.) The balance of $44.84 will be included in income.

Joint and survivor annuity (variable payments). *Example:* A purchases for $50,000 an annuity contract which will pay him and his wife $260 per month for life and, after his death, payments to his wife of $130 per month for life. At the date of the first annuity payment, their joint life expectancy is 23 years. (See Table II of Temporary Regulation for Sec. 72.) The life expectancy of A is 15 years. (See Life Annuity example.) The difference between A's and his wife's combined life expectancy (23 years) and A's life expectancy alone (15 years) is 8 years. The expected return under the contract is $59,280 [(15 × 260 × 12) plus (8 × 130 × 12)]. 50,000/59,280 equals 84.34 per cent. This percentage of

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(3% × $8,500) and $281.40 is exempt ($536.40 – $255.00). The life expectancy of the beneficiary was about 21 years but he would have to live nearly 10 years beyond this life expectancy to recover his entire cost tax-free.

each payment is received tax free and the balance or 15.66 per cent is in income.

Joint life annuity (variable payments). *Example:* A purchases for $50,000 an annuity contract which will pay him and his wife $270 per month while they are both living. Upon the death of either, payments to the survivor will be $135 per month for life. (The distinction between the Joint and Survivor Annuity and the Joint Life Annuity is that in the former, the payments are only reduced in the event of the death of the primary annuitant, while in the latter, payment to the survivor is reduced in the event of the death of either the primary or secondary annuitant.) The date of the first annuity payment for their joint life expectancy is 23 years. (See Table II of Temporary Regulation for Sec. 72.) This multiple is reduced by 11.5 (the multiple found in Table IIA). The expected return under the contract is $55,890 computed as follows: (11.5 × 135 × 12) plus (11.5 × 270 × 12). To compute the percentage of each payment excluded from income tax, divide the deposit by the expected return (50,000 ÷ 55,890 = 89.4%, roundest to the nearest tenth). The balance of 10.6% is subject to ordinary income tax.

Dividends received as part of annuity proceeds after January 1, 1954 are to be subject to income tax in full.

Any annuity payments received tax free prior to January 1, 1954 will be deducted from the net paid premiums to determine adjusted net cost. This adjusted value will then be subject to Section 72 using the life expectancy of the annuitant as of January 1, 1954. The excluded part of each payment is then determined by dividing adjusted net cost by the remaining number of installments.

Example: A purchases for $50,000 an annuity contract which will pay him $5300 per year for 10 years. A received his first annual installment in 1953. Under prior law, no part of the proceeds was subject to income tax. Therefore, in the taxable year 1954, the net cost of the contract ($50,000 less $5300, or $44,700) is divided by the remaining fixed number of installments (9). This is $4,966.67, the annual portion to be excluded, while the difference ($333.33) is subject to income tax.

If payments are made for life, whether under an annuity, endowment, or life insurance contract (paid other than by reason of the insured's death), proceeds are taxed as described earlier.

If proceeds are taken in a single sum under a life insurance, endowment or annuity contract, the tax is computed as under prior law but it cannot exceed the tax which would be payable if proceeds had been received equally in three installments, one in the year of receipt, and the other two in the two preceding years.

To avoid ordinary income tax treatment of excess of cash available less net premiums paid, some policyholders are selling their contracts to third parties believing that the excess referred to above will be subject to capital gains. If an insurance contract is not a capital asset then its sale to a third party would not result in the gain. If an insurance contract is a capital asset there is still a question as to its tax treatment in a sale to a third party.[22]

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[22] In *F. Rodney Paine et al.* v. *Comm.*, 23 T.C. 391, the court held that the sale of notes to a third party just before maturity resulted in the gain being taxed as ordinary income.

If a fixed number of installments (not dependent on recipient's life expectancy) is used, the excluded part of each installment is found by dividing the net cost of the contract by the fixed number of installments.

Example: A purchases for $50,000 an annuity contract which will pay him $5,300 per year for 10 years. The net cost of the contract ($50,000) is divided by the fixed number of installments (10). This is $5,000. Therefore, $5,000 of each annual installment is excluded while the difference ($300) is subject to income tax on ordinary basis.

The rules described above apply to amounts received under a matured endowment contract if the policyholder elects to take such payments within 60 days after he has the right to receive a single sum. If the policyholder elects to take income payments after the 60 days, then the lump sum will be taxable in the year of maturity under the doctrine of constructive receipt.

Interest payments continue to be fully includable in gross income if any amount is held under an agreement to pay interest thereon.

Comment. 1. Under prior law where the amount paid for the annuity represented a large proportion of its value at the time payments began, the annuitant was rarely able to receive tax-free the amount he paid for the annuity. Where the amount paid for the annuity represented a small proportion of its value at the time payments began, the exclusion was used up rapidly. This resulted in forcing the annuitant to reduce his standard of living after the exclusion was dissipated because of the annuity becoming fully taxable at a time when he could least afford it.

The new law, on the other hand, provides for spreading the tax-free part of annuity income evenly over the annuitant's lifetime even though he should outlive his life expectancy. This helps the annuitant in his planning and does not cause reduction of living standards because of increase in income subject to tax as under prior law.

2. Tax treatment, under new law, of proceeds taken in a single sum under a life insurance, endowment or annuity contract gives the recipient an income tax advantage over prior law because the tax on the gain is divided over a three-year period instead of being taxable in one year.

3. Under prior law, the dividends were added to the guaranteed value of the annuity and the gross sum was subject to the life expectancy rule. The dividends are now treated separately, being taxable as ordinary income. The probable reason for this change is that such dividends cannot be anticipated as of the annuity starting date and, therefore, cannot be determined in computing the exclusion ratio.

4. Under prior law, the courts held that the proceeds of an annuity, endowment or life insurance contract were taxable under the 3 per cent annuity rule only if the installment payments were computed by reference to life or mortality tables. However, under new law, the annuity method of taxation also applies where installment payments are payable over a fixed number of years.

4. Certain Death Benefits

SECTION 101 (formerly Section 22(b)(1))

A. Section 101(a): PROCEEDS OF LIFE INSURANCE CONTRACTS PAYABLE BY REASON OF DEATH; Section 101(d): PAYMENT OF LIFE INSURANCE PROCEEDS AT A DATE LATER THAN DEATH.[23]

Purpose. To retain the general rule relating to the taxability of life insurance proceeds payable by reason of the death of the insured, while modifying the tax treatment of life insurance proceeds payable at death where the contract has been transferred for valuable consideration. To place a limit on the exemption granted to interest earned on life insurance proceeds distributed in installments.

Prior law. Life insurance proceeds payable by reason of the death of the insured are exempt from tax.[24] The exemption is applicable whether the proceeds are payable in a single payment or in installments, and even though such installments include a *guaranteed* interest. This exemption does not apply where an insurance policy is transferred for valuable consideration to anyone other than the insured, unless the transferee's basis is determinable to any extent by reference to the transferor's basis.[25] The proceeds of any policy transferred for consideration, other than as above provided, will be exempt to the extent of the consideration paid for the transfer plus the total premiums thereafter paid by the transferee.[26] However, any dividends added to the installments or *excess interest* will be taxed as ordinary income.[27]

Example: Upon the death of H, W is entitled to receive a $10,000 life insurance policy in a single sum or 10 annual installments of $1200. W is not taxable on either receipt of the single sum or on any part of the installments. If, in addition to the annual installments, a $20 dividend is paid, then W will be taxable on such excess.

New law. The new law restates the general rule specifically exempting from gross income the receipt of life insurance proceeds paid by reason of the death of the insured, whether received by the decedent's estate, beneficiary or otherwise.[28] This exemption continues to be applicable without regard to whether the insurance is payable in a lump sum or in installments, except in certain cases where there is a transfer for valuable consideration, and with respect to certain interest payments made in connection with life insurance payable in installments.

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[23] Section 101(a) and 101(d) correspond to Section 22(b)(1)(A) IRC 1939 and because of their interrelated nature these subsections are discussed together.

[24] Where the insurance contract includes no option, and beneficiary and insurer enter into a supplemental agreement under which beneficiary receives proceeds under an installment basis, any such payments will be made *other* than by reason of the death of the insured. If such installments are computed with reference to life or mortality tables, they are taxable as annuities; and if not so computed, the installment payments will probably be exempt until the aggregate payments are equivalent to the face amount of the policy.

[25] In the transfer of an insurance policy in lieu of alimony, the wife is taxable on the husband's prior death on that portion of the proceeds which exceeds her cost. Her costs are determined by taking a fair market value at the time of the policy's assignment plus any premiums paid by her or thereafter paid by her husband and which are income to her. See Section 71 for new law.

[26] Section 22(b)(2) IRC 1939, Reg. 39.22(b)(2)-3. Either the insured or the beneficiary may select the option to receive the proceeds in a single sum or in installments without change of tax consequences.

[27] H. Rep., p. 832 and Sen. Rep., p. 182 summarize prior law as follows: "Under present law 'guaranteed' interest is regarded as an amount paid by reason of death of the insured and is excluded from gross income although so called 'excess' interest is regarded as an amount not paid by reason of death of the insured and is included in gross income."

A transfer for valuable consideration where the transferee's basis is determinable to any extent by reference to the transferor's basis or where the transfer is to the insured, will not lose this exemption. This is the same as prior law. A transfer for valuable consideration to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a stockholder or officer, will not lose this exemption. This provision liberalizes prior law, but is limited to these specific exceptions.[29]

A limitation on the exemption granted by prior law to guaranteed interest earned on life insurance proceeds left with the insurance company and payable in installments is introduced by the new law.[30] Provision is made that as of the date of death of the insured, the value of the policy is to be prorated over the period with respect to which the installments are to be made, and such prorated amounts are to be excluded from gross income regardless of the taxable year in which they are received. Where the annual exclusion is based on the life expectancy of the beneficiary, then as in the case of regular annuities, the prorated exclusion is allowed annually as long as the beneficiary lives.[31] Amounts paid in excess of this prorated exclusion will be taxable as interest except that the surviving spouse of the insured is entitled to a $1,000 annual exclusion against any such interest.

Example: Upon the death of H, W is entitled to receive a $100,000 life insurance policy in a single sum or in 10 annual installments of $12,000. Under prior law, the exemption with respect to proceeds of the life insurance would have applied in the selection of either option of payment. Under new law, the election to take a single lump sum payment is subject to the exemption, but with respect to the installment option, $2,000 of each annual payment will be subject to income tax, unless W is a surviving spouse entitled to the additional exclusion, in which event, only $1,000 is subject to tax.[32]

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[28] H. Rep., p. 829 and Sen. Rep., p. 180 notes that Section 101(a) excludes "death benefit payments under Workmen's Compensation insurance contracts or under accident and health insurance contracts which have the characteristics of life insurance proceeds payable by reason of death."

[29] The House bill of Section 101(a), granted full exemption to life insurance proceeds payable at death without regard to whether or not the contract had been transferred for valuable consideration. The Senate, confirmed by the Conference Committee, modified this liberalization of prior law, stating, Sen. Rep., p. 814: "Your committee believes that the procedure in the House bill may result in abuse in encouraging speculation on the death of the insured and therefore has reinstated present law. . . . However, it is made clear that complete exemption is to be granted to life insurance proceeds paid under contracts which have been transferred for certain legitimate business reasons rather than for speculation purposes." Conf. Rep. Amendment No. 28, p. 23.

[30] The House bill, Section 101(d), limited the interest exclusion payable in connection with life insurance installments to $500 a year for a widow of a decedent and $250 a year for lineal descendants and certain ancestors of the decedent. The Senate modified this provision substituting for the exclusions provided by the House a $1,000 a year exclusion for the widow, stating Sen. Rep., p. 15, "The widow is granted the exclusion to encourage her to take the life insurance proceeds in instalments so as not to waste the principal. There appears to be little reason to grant an exclusion to children since even if the mother is dead, their interest in the principal is protected by guardianship laws while they are young. Moreover, when children reach majority there appears to be no reason to encourage them to leave the proceeds in any particular form." Conf. Rep., Amendment No. 29, p. 24.

[31] H. Rep., p. A32 and Sen. Rep., p. 182 indicates that regulations will be issued to provide rules for computing the yearly exclusion covering settlement options which contain refund features. In making this computation, the actuarial value of such refund features will be excluded. A surviving spouse is defined by Section 101(d)(3) as meaning "the spouse of the insured as of the date of death, including a spouse legally separated but not under a decree of absolute divorce."

Comment. The relief granted will permit a stockholder to transfer life insurance on his life to his closely held corporation, thereby siphoning off an amount equal to its fair market value, without tax consequence. Since the stockholder is already in control of the corporation, he loses none of the economic benefits which he possessed when he personally retained ownership. Further, the tax-free exchanges of insurance should encourage the use of life insurance to fund buy and sell, stock retirement, and other buy-out agreements.

However, the exemption of life insurance proceeds paid under contracts transferred for what the Senate calls "certain legitimate business reasons" is discriminatory.[33]

In addition to those specific transactions enumerated in Section 101(a)(2), there are other equally legitimate business transactions which are not given exempt status. For example, if the transfer is to a partner of the insured, the insurance proceeds escape taxes, but if the transfer is to a shareholder in a closely held corporation, which is substantially the same as a partnership, the excess of proceeds over the consideration and premiums paid appears to be subject to tax. Or, a corporation is entitled to purchase an existing policy of insurance on the life of a key employee if he is a shareholder or an officer, without losing this exempt status; and in contrast, a partnership is not entitled to similarly purchase an existing policy of insurance on the life of any key employee, such as a general manager, unless he is also a partner.

It should be noted that while a transfer between family members, without consideration, retains the exempt status with respect to insurance proceeds, under the provisions of 101(a)(2), such a transfer for consideration would not in and of itself be similarly tax exempt. Even though such a transfer may not qualify under the enumerated "legitimate business reasons," there seems to be no logical reason for this distinction.

Taxing the interest element earned on proceeds left with insurance companies and paid in installments opens the door to further limitations in this regard, reducing the value of life insurance as an investment. Except as the surviving spouse's $1,000 yearly exclusion applies, formerly tax exempt income becomes fully taxable.

B. Section 101(b): EMPLOYEES' DEATH BENEFITS.

Purpose. To modify the rules applicable to employees' death benefits.

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[32] H. Rep., p. A31, and Sen. Rep., p. 181 discuss the problem arising where the insurance contract does not include an option to pay a particular amount immediately upon the death of the insured, and suggests that the problems arising are to be solved "by finding the value (with respect to each beneficiary on a particular contract) of the agreement, as of the date of the death of the insured, discounted on the basis of the interest rate and mortality tables used by the insurer in determining the payments." See illustration H. Rep., p. A31, Sen. Rep., pp. 181-182.

[33] See footnote 29, above.

Prior law. Under prior law, beneficiaries of a deceased employee are given an exclusion up to $5,000 from each employer, if the payment is made because of the death of the employee and pursuant to a contract giving the employee's beneficiary a legal right to the payment.

Payments may be made in a lump sum or in installments. Any interest paid on an amount held by an employer is considered taxable as interest.

A beneficiary is entitled to receive the maximum death benefit exclusion from each employer of the decedent. A beneficiary of several deceased employees is entitled to this exclusion with respect to each employee.

Example: A is employed by X, Y and Z. B is employed by X. C is the sole beneficiary of A and B. A and B have entered into employment contracts providing for payment of $5,000 death benefits with respect to each of their employers. Upon A's death, C is entitled to an exclusion of $15,000; upon B's death to an exclusion of $5,000. If the deaths of A and B occur in the same year, C is entitled to receive $20,000 free of taxes.

However, where there are several beneficiaries, the exemption applicable to the payment of each employer must be prorated among the beneficiaries. In a case where an employer contracts to pay in excess of the $5,000 exemption, the amount of exclusion for each beneficiary will be in the same ratio to the total amount of exclusion as the payment received by each beneficiary bears to the aggregate payments to the beneficiaries.

Example: Upon employee A's death, X is obligated by a written employment agreement to pay A's widow $5,000, A's daughter B $3,000 and A's son C $2,000. The widow excludes $2500, the daughter $1500 and the son $1,000.[34]

Apparently, the tax-free death benefits received by the decedent's beneficiaries would be includable in the decedent's estate. Moreover, where the employer funds its obligation by purchasing a life insurance policy on the life of an employee, the company will receive such funds free of any tax. As indicated elsewhere in this article, under prior law the payment of premiums on such a policy is not deductible, but also, the premiums are not income to the employee. Regardless of whether or not the obligation has been funded, the company receives a deduction for the death benefit payment.

New law. Prior law is re-enacted with several important substantive changes.

Beneficiaries of a deceased employee are limited to an exclusion of $5,000 for each employee, regardless of the number of employers making payments.[35] The exclusion is available regardless of whether the employer is contractually obligated to pay any death benefits.[36]

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[34] If payments to any beneficiary are made in installments covering more than one calendar year, the amount excluded will be similarly prorated. So, in the example to which this footnote refers, if A died in 1951 and the widow received $2,500 in 1951, $1,500 in 1952 and $1,000 in 1953, she would be entitled to a tax free exclusion in each of those years of $1,250, $750, and $500, respectively.

[35] The purpose of this change is ". . . to prevent individuals from increasing the exemption by arranging to have two or more employers each pay $5,000 in death benefits." See Sen. Rep., p. 14.

[36] H. Rep., p. 14 cites the following reason for this change: "Restricting the exemption to benefits paid under a contract discriminates against those who receive benefits where this contractual obligation does not exist."

The exclusion is not applicable to amounts to which the employee had a nonforfeitable right prior to his death, with one exception—distribution under a qualified employees' pension, profit sharing, stock bonus, or qualified annuity plan, if total distribution is made within one taxable year after the decedent's death and by reason of the employee's death.[37]

However, the amounts paid under a joint and survivor annuity to the survivor are excepted from this exclusion if the employee was entitled to receive any portion of the annuity before his death. Other annuities under Section 72 will qualify to the extent that the value of the annuity, as determined on the date the employee died, exceeds the value of the nonforfeitable right. Any amount so excluded is to be added to the survivor's basis.[38]

Comment. The new provision, limiting death benefits to a total of $5,000 for each employee, plugs a loophole. Taxpayers having provisions for death benefits in excess of the statutory limitation are advised to review the consequences of this change. On the other hand, the employer, no longer required to enter into a binding agreement to afford tax-free death benefits to his employees' beneficiaries, has acquired an advantage usually reserved for the Internal Revenue Service —the advantage of hindsight. The employer may determine at the time of an employee's death whether the voluntary death payments then serve the best interests of his business. This modification in the law will tend to discourage formal binding agreements.

As under prior law, it would seem that the death benefits would be included in the employee's gross estate for estate tax purposes. If the intention of the law is to provide certain limited benefits for beneficiaries of decedents, it would seem logical to exclude this same amount from estate tax.

5. Certain Amounts Paid in Connection with Insurance Contracts

SECTION 264 (formerly Section 24(a)(4)(6) IRC 1939)

Purpose. To retain prior law relating to deductibility of life insurance premiums. To extend the denial of the interest deduction to single premium annuity as well as other single premium insurance contracts, and to prevent avoidance of this restriction by extending the single premium definition to cases where money is deposited with an insurer for payment of a substantial number of future premiums.

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[37] The Senate amended the House bill to include qualified pension plans, stating (Sen. Rep., p. 15), "The purpose of this change is to provide uniform treatment for lump-sum distributions granted because of death by the various types of employee plans." Further the definition of nonforfeitable rights was amended by a Senate floor amendment to include certain annuity contracts under plans covered by Section 401(a).

[38] 101(c) corresponds to prior law and provides that where life insurance proceeds are excluded from gross income under Section 101(a) or (b) and are held under agreement to pay interest thereon, the interest payments are included in gross income. Section 101(e) provides that the entire section is not applicable to any payments includable in gross income of the wife under Sections 71 (relating to alimony) or under Section 682 (relating to income of an estate or trust in the case of divorce, etc.). Section 101(f) provides that the entire section shall only apply to amounts received by death of an insured employee occurring after the passage of the Act; and that Section 22(b)(1) IRC 1939 is to apply to any amounts so received before such date. Therefore, if the insured died before the date of enactment, prior law still applies.

Prior law. Under prior law, life insurance premiums are not deductible where the policy covers the life of an officer, employee or other individual financially interested in taxpayer's trade or business, and where the taxpayer is a direct, or indirect, beneficiary thereunder. Where, however, the taxpayer is not a beneficiary, then the premiums may be a deductible expense, if ordinary and necessary in connection with carrying on a trade or business, or in the production or collection of income, or in the conservation, maintenance and management of property held for the production of income.[39]

In the case of an indebtedness, incurred or continued, to purchase a single premium life insurance or endowment contract, no interest deduction is permitted. Furthermore, if substantially all the premiums on a life insurance or endowment contract are paid within four years from the date of issuance, the contract is treated as a single premium contract and the limitations applicable thereto apply. This loss of an interest deduction has been avoided by borrowing funds equivalent to the cost of the single premium policy (thereby securing an interest deduction), and depositing the borrowed funds with the insurer to pay the future premiums over a period in excess of four years.[40]

Denial of this interest deduction is not applicable to any indebtedness incurred in the purchase of a single premium annuity contract.[41]

New law. This section re-enacts, in substance, prior law except that it purports to close up two loopholes involving interest deductions on money borrowed to buy insurance:

1. A deduction is denied for interest on an indebtedness incurred to purchase a *single premium annuity contract* as well as on a single premium life insurance or endowment contract.
2. The definition of "single premium" is broadened to include the situation where an amount is deposited with the insurer for the payment of a *substantial* number of future premiums as well as to include the payment of substantially all the premiums within four years.

To avoid a retroactive application of these changes, the denial of an interest deduction applicable to single premium annuities and with respect to amounts deposited under life insurance, endowment and annuity contracts for the payment of future premiums, is made applicable only to such transactions occurring after March 1, 1954.[42]

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[39] Generally insurance premiums are deductible only where: (1) an employer pays premiums on a policy on the life of an employee and the premiums are included as income of the employee and the employer has no rights under the policy, (2) a charity is the beneficiary, (3) the premiums are paid under certain alimony arrangements, (4) insurance is used as security for a debt. Persons financially interested include not only stockholders, and partners, but all others who may have an interest in the profits of taxpayer's trade or business.

[40] In criticizing the status of prior law, H. Rep., p. 31 and Sen. Rep., p. 38 observe: ". . . a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from omission of annuities from the treatment accorded single-premium life-insurance or endowment contracts. The annuity is sold for a nominal cash payment with a loan to cover the balance of the single-premium cost of the annuity. Interest on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest cost below the increment in value produced by the annuity."

[41] Sen. Rep., p. 38 states: "In the case of life-insurance contracts, a method has been devised to avoid the limitation on the interest deduction for indebtedness on single-premium contracts. The purchaser borrows an amount approximating the single-premium cost of the policy but, instead of purchasing the policy outright, deposits the borrowed funds with the insurance company for payment of future premiums on the policy. The bill will prevent this type of avoidance."

Comment. The use of the language "after payment of a substantial number of future premiums on a contract" in Section 264(b)(2) is indefinite. The word "substantial" leaves the taxpayer to speculate as to the number of future payments which will result in the insurance contract being treated as a single premium.[43]

6. Amounts Received by Survivor Annuitant Under Joint and Survivor Annuity Contract

SECTION 691(d)[44] (formerly Sections 22(b)(2) and 113(a)(5))

Purpose. To provide a deduction against the income of the survivor annuitant offsetting any income tax element of a joint and survivor annuity included in the estate tax valuation of such joint and survivor annuity.

Prior law. Under prior law any part of the survivorship interest of a joint and survivor annuity is included in the decedent's gross estate, the basis of that interest to the survivor being the estate tax value of the survivor's interest.[45] Therefore, the survivor annuitant is permitted to apply the 3 per cent rule, not only to the remaining unrecovered cost of the annuity, but to a stepped-up basis determined by the estate tax value of the annuity in the decedent's estate.[46]

New law. With respect to a joint and survivor annuity, where the primary annuitant dies on or after January 2, 1954, the exclusion ratio determined under Section 72 is to be used by the survivor annuitant as a deduction in the taxable year received, based on the estate tax attributable to the estate tax value of the annuity in the survivor's hands.[47]

A complicated formula for computing this deduction is found in the general provisions of Section 691 applicable to income with respect to decedents.[48] The effect of Section 691(d) is to spread "the estate tax, attributable to the net value for estate tax purposes of the annuity, over the life of the survivor, in such a way that it will be fully allowed as a deduction against income, if the survivor reaches his life expectancy (determined at the date of the death of the deceased annuitant)." [49]

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[42] Under the House bill denial of the interest deduction pertaining to annuities was applicable to annuities purchased after March 1, 1954; however, the House provision with respect to denial of the interest deduction, where the owner deposits borrowed funds with the insurer for payment of future premiums, would have been retroactive. The Senate, confirmed by the Conference Committee, made both changes applicable only to transactions occurring after March 1, 1954. Sen. Rep., p. 226; Conf. Rep., Amendment No. 76, p. 32.

[43] See Senate Hearings, pp. 548, 2262-2263.

[44] The Senate, approved by the Conference Committee, deleted 72(j) and included the same provision under 691, Recipients of Income in Respect of Decedents, indicating that the subject matter would be better handled under this latter section. Sen. Rep., p. 88; Conf. Rep., Amendment No. 176, pp. 57-58.

[45] This basis for the survivor's interest applies only to cases where the annuitant has died after December 31, 1950.

[46] The survivor annuitant is entitled to this basis even though the estate is not required to pay any estate tax.

[47] The discussion under Section 72 notes that the primary annuitant is treated as any other annuitant under an ordinary annuity contract. Section 691(d) provides special treatment of the survivor's interest in an annuity. With respect to the primary annuitant dying after 1950 and before 1954, see the discussion under Section 72. Section 72(i) specifically provides that in such instances the survivor annuitant's investment in the contract used in determining his annual exclusion is to be computed under Section 113(a)(5) IRC 1939, less any amounts recovered taxfree before the annuity starting date.

If the survivor annuitant receives the annuity beyond his life expectancy period, no further deduction is permitted. If he dies before the expiration of his life expectancy period, no compensating adjustment for any unused deduction is allowed.[50]

Comment. The rules necessary to compute the deduction permitted by this section are burdensome and complicated. Considerable effort will be required not only in the comprehension of the basic formula, but in the construction of the language employed.

7. Sale of Annuities

SECTION 1021 (new provision)

Purpose. To prevent the operation of Section 72 from resulting in a basis less than zero in the case of a sale of an annuity contract.

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[48] Instead of obtaining a stepped-up basis provided by prior law, the survivor is entitled to a deduction for the taxable year in which income is received in an amount to be computed as follows:

(1) Determine the net value for estate tax purposes of the joint and survivor annuity
  (a) by computing the excess of the value of the annuity at the decedent annuitant's death over the total amount excludable from the gross income of the surviving annuitant under Section 72, during the period of his life expectancy, and
  (b) multiplying the figure so obtained by the ratio which the value of the annuity, for estate tax purposes, bears to the value of the annuity at the date of the decedent annuitant's death; and then
(2) take as a deduction an amount which bears the same ratio to the estate tax attributable to the net value, for estate tax purposes, as determined in (1) above, of the joint and survivor annuity, as the value for estate tax purposes of the portion of the survivor's annuity which represents the excess interest earned, while the annuity was held jointly, bears to the value for estate tax purposes of the items described in Section 691(a)(1).

See Conf. Rep., Amendment No. 176, pp. 57-58, accepting the Senate version, as above.

[49] Sen. Rep, p. 375. The purpose of this complicated formula is perhaps explained by the Sen. Rep., p. 89 as follows:

> "Under Section 72 in a joint and survivor annuity, an exclusion ratio will be determined which will indicate the average interest earnings over the combined lives of the two annuitants. The survivor will continue to use this exclusion ratio although somewhat less interest than this will be earned in the latter years while she is receiving an annuity and more interest than this will be earned in the early years while they are both receiving the joint annuity. The provisions contained in subparagraph (C) in both paragraphs (1) and (2) of subsection (c) of Section 691 are designed to provide a deduction to the survivor based upon the estate tax attributable to a portion of the survivor annuity which represents the excess interest earned while the annuity was being received jointly. This is, in effect, income in respect of a decedent. This deduction will be spread ratably over the life expectancy of the survivor."

[50] "Life expectancy" is defined as the period beginning with the first day of the first period for which an amount is received by the surviving annuitant and ending with the close of the taxable year in which his life expectancy terminates. Computation of the surviving annuitant's life expectancy and expected return under a joint and survivor annuity contract is to be made with reference to actuarial tables designated by the Secretary of the Treasury.

New law. The section provides that where there is a sale of an annuity contract, the adjusted basis of such annuity contract shall not be less than zero. The basis to a taxpayer in the case of the sale of an annuity contract is his cost less any amount of tax-free annuity payments received by him, but in no event shall the basis be less than zero.

Consequences of this section may be best illustrated by the following:

Example: Assume that taxpayer purchases an annuity contract for a cost of $10,000. He receives payments of $2,000 annually and has a life expectancy of six years. Under the provisions of Section 72, $1,666.67 of each such payment is excluded from income and $333.33 is included in income. If he is still living after eight years, he will have collected gross payments of $16,000, of which $13,333.36 will have been excluded from income. Assume that the taxpayer then sells the annuity contract for $8,000. Even though he has, prior to the sale, received $6,000 more than his cost in the contract,[51] his basis in the contract, pursuant to Section 1021, cannot be reduced to less than zero. Therefore, the capital gain recognized is limited to $8,000.

Note, however, that the sale by the taxpayer of the annuity contract results in taxpayer losing the benefit of the annual payment ($1,666.67 not subject to tax and $333.33 subject to tax).

Comment. The taxpayer must, before making any such sale, determine whether or not the net amount he retains after such sale is greater than the amount he can anticipate receiving from the annuity as of the date of making such sale. This determination, of course, will depend upon the taxpayer's life expectancy and the advantage of having greater immediate funds.

8. Certain Exchanges of Insurance Policies

SECTION 1035 (no specific corresponding section under prior law)

Purpose. To provide for the non-recognition of gain or loss on the *exchange* of an insurance contract for the same or different type of insurance contract issued by life insurance companies.

Prior law. When an old policy is exchanged with the insurer for a new policy, the excess of the fair market value of the contract received over the net cost of the contract exchanged is taxable income. Even though the exchange is for a policy better suited for the insured's needs and no actual gain is realized, the transaction is taxable. Any loss sustained, whether or not the transaction is entered into for profit, is not deductible on the theory that the owner has received consideration equivalent to the loss claimed, since the difference between the premiums paid and the policy's cash surrender value is part of the cost of the current insurance coverage.

Where a policy is assigned to a third party for consideration, instead of surrendering or exchanging the policy with the insurer, any profit is subject to tax and, probably, as a capital gain.

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[51] $3,333.36, not subject to taxes, more than his cost in the contract, as well as $2,666.64, subject to tax.

New law. In general, the new law permits the tax-free exchange of life insurance, endowment or annuity contracts for any of said contracts. The following specific exchanges continue to be taxable:

1. endowment for life insurance or another endowment which provides for payments beginning at a date later than provided under the contract exchanged,[52] or
2. annuity for life insurance or endowment.

The change in the law, permitting certain tax-free exchanges, is designed to eliminate taxing an individual who exchanges one form of policy for another more suitable form, not having actually realized any gain. The exceptions have been retained to prevent tax avoidance by conversion at maturity of endowment or annuity contract into life insurance or endowment contract, whose proceeds, payable at death, are tax exempt.

In a non-taxable exchange, the taxpayer will take as his basis, on the contract received, the basis of the contract exchanged. Any gain not recognized at the time of the exchange will be taxed as ordinary income when the proceeds from the contract received become due and payable. In an otherwise non-taxable exchange where money or other property is received, an adjustment is made in the basis of the contract received. The basis of the contract received will be the same as the contract exchanged, after deducting the amount of the money or other property received, and adding the amount of gain recognized. The resulting basis is to be allocated among the properties, other than money, in an amount equivalent to their fair market value at the date of the exchange.

In the event of a loss, no deduction will be allowed.

Comment. From the Senate and House reports, it appears that the new law is intended to cover only those situations in which there is an exchange of an old insurance policy with the *insurer*, and transactions involving an exchange with *third parties* are still controlled by prior law. However, as presently drafted, Section 1035 would seem to apply to exchanges of insurance contracts issued by life insurance companies, as defined in Section 801, between not only the owner and insurer, but between owners of such insurance contracts. If the statute is to be taken literally, an exchange of life insurance, endowment or annuity contract with a *third party* will also be covered by the new law.[53]

The definition of insurance policies in Section 1035 is applicable to that section only. Whether the definitions will prove to be inequitable or discriminatory remains to be tested by their application.[54]

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[52] The House bill provided for a tax-free exchange of an endowment contract for another endowment contract, or for an annuity contract. The Senate modified this provision to provide that no gain or loss shall be recognized in the exchange of an endowment contract for another endowment contract if the contract received provides for regular payments beginning on or before the date that the payments would have begun under the contract exchanged. No indication is given whether or not such "regular" payments must be in substance "identical" payments.

[53] Sen. Hr., p. 622; Sen. Rep., p. 428.

[54] Sen. Rep., p. 428; Sen. Hr., p. 1565.

9. Exchanges of Property for an Annuity Contract

SECTION 1241 (House bill—no specific corresponding section in prior law)

Purpose. To establish criteria for taxing private annuities, that is, the exchange of property in return for an agreement to make a series of payments contingent upon the seller's or some other person's life expectancy.

Comment. The Senate, approved by the Conference Committee, rejected this section to provide an opportunity for further study of the problem. The rules formulated by the House while purporting to settle some conflicting court decisions would have severely restricted the present tax advantages of private annuities.[55] In any event, it may be assumed that present law affecting this subject is due for a change.

10. Annuities (Re Estate Tax)

SECTION 2039 (no specific corresponding section in prior law)[56]

Purpose. To clarify estate tax treatment of the survivor's interest in an annuity or similar contract.

Prior law. Under prior law, the estate tax value of survivorship benefits in an annuity, purchased by decedent, is included in his gross estate as a transfer taking effect in enjoyment or possession at or after death. No value is includable in the estate of a decedent who has not, directly or indirectly, paid any part of the purchase price. If the surviving beneficiary has contributed part of the purchase price, a proportionate reduction is made in the value included. If the annuity is purchased by decedent's employer, in part or in whole, the prior law is unclear as to what should be included in decedent's estate.

New law. The new law provides for inclusion in the decedent's gross estate of the value of an annuity, or similar payment, under any contract other than insurance on the decedent's life, if[57]

1. payable to decedent, or if the decedent possessed the right to such payment, alone or with another, during his life,[58] or
2. receivable by any beneficiary by reason of surviving the decedent.

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[55] Sen. Rep., p. 116, Conf. Rep., Amendment No. 251, p. 71.

[56] While there are no specific provisions of prior law available comparable to Section 2039, survivorship benefits are included in the decedent's estate under the general provisions of Section 811 IRC 1939.

[57] The Senate, approved by the Conference Committee, changed the language "other payment" to "similar payment" in Section 2039(a) to make clear that the provisions of this section "apply not only to cases where an annuity was payable to a decedent, but also to contracts or agreements under which a lump-sum payment was payable to the decedent or the decedent possessed the right to receive such a lump-sum payment in lieu of an annuity." Sen. Rep., p. 470; Conf. Rep., Amendment No. 269, p. 74. This section does not cover insurance contracts on decedent's life, to which Section 2042 is applicable. Further, this section applies only to annuity and other similar contracts entered into after March 3, 1931.

[58] "The provisions of this section are applicable only to annuities or *other* payments payable to the decedent, or which the decedent possessed the right to receive, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in effect end before his death." Sen. Rep., p. 472.

The amount included is that part of the value at decedent's death which is proportionate to that part of the purchase price contributed by the decedent. Thus, if decedent contributed one-half the cost of the contract, one-half of the value would be includable in decedent's gross estate.

It is immaterial whether the payments to the surviving beneficiary are in a lump sum, in installments, in the same or in a greater or lesser amount than the annuity or other payment to decedent.

Where an annuitant dies prior to receipt of the first payment, the excess of the cash surrender value over the amount paid is ordinary income taxable to the beneficiary in the year received.[59]

Contributions by decedent's employer to the purchase price of an annuity, or similar contract, if made by reason of decedent's employment, will be considered to have been made by decedent unless made under certain qualified plans.

Comment. This section does not prevent the application of other estate tax provisions. The Senate Finance Committee cites as example, a refund payable to decedent's estate in the event of decedent's premature death. This amount would be taxable as other property belonging to the decedent.[60]

11. Proceeds of Life Insurance

SECTION 2042 (formerly 811(g))

Purpose. To retain prior law, requiring inclusion of life insurance proceeds on decedent's life in decedent's estate, where the policy is owned by him or payable to his executor. To change prior law by eliminating the payment of premiums as a test of ownership, but to add as a new test of ownership, the retention of a reversionary interest exceeding 5 per cent of the value of the policy.

Prior law. Proceeds of insurance upon the life of a decedent are taxable in decedent's estate when: (1) receivable by the estate, executor, or administrator, or (2) decedent, directly or indirectly, pays the premiums or other consideration (but such proceeds are includable in decedent's gross estate only in proportion that the amount so paid bears to the total consideration), or (3) decedent possesses at his death any of the incidents of ownership (excluding a reversionary interest), exercisable either alone or in conjunction with any other person, or (4) decedent transfers the policy in contemplation of death, or (5) decedent's prior transfer is not effective until death.[61]

New law. Insurance proceeds on decedent's life continue to be taxable in decedent's estate as under prior law with two exceptions:

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[59] Rev. Rul. 55-313, IRB 1955-21, 20.

[60] The refund would be taxable under Section 2033.

[61] Under prior law, premiums paid by decedent on or before January 10, 1941, are excluded in applying this proportion if decedent at no time thereafter possesses any incident of ownership. Note that while under the payment of premiums test only part of the proceeds may be includable in decedent's estate, that if any other test is present the entire proceeds will be subject to estate tax. Under 811(g)(2) IRC 1939, a reversionary interest is specifically excluded as an incident of ownership. "Incidents of ownership" is defined in Reg. 105, Section 81.27 as including the right of the insured or estate to any of the economic benefits under the policy such as the power to change the beneficiary, surrender, cancel, assign, pledge, borrow, etc. "Contemplation of death" in respect to the transfer of an insurance policy is no different than when applied to other property. No negative inferences are to be drawn from the "inherent" testamentary nature of an insurance policy.

1. The *premium payment test* is eliminated as a criterion for inclusion of life insurance proceeds in decedent's estate, and
2. The definition of *incidents of ownership* has been expanded.

Under prior law, a "reversionary interest" is specifically excluded as an "incident of ownership." The new law defines incident of ownership as specifically including a reversionary interest (whether arising by the express terms of a policy or other instrument or by operation of law), but only if the value of such reversionary interest exceeds 5 per cent of the value of the policy immediately prior to decedent's death.[62]

Comment. The statute provides for inclusion in the gross estate of amounts receivable under policies on the life of the decedent, if immediately prior to his death, he has a reversionary interest exceeding 5 per cent of the value of the policy. The concept of the "value of the policy" is ambiguous. It might mean face value, cash surrender value or market value. Many policies, such as certain term or new contracts, may be considered to have no value immediately prior to decedent's death. Apparently, in such cases, there would never be a reversionary interest. To avoid this construction, "value of the policy" will have to be interpreted to mean that if a taxpayer has a 5 per cent chance of getting back any interest in the policy, it will be considered a reversionary interest.[63]

Further, there is a question where an absolute conveyance is made whether any reversionary interest exists even though, according to the applicable Actuaries Table, the taxpayer has a 5 per cent chance through inheritance of getting back any interest under the policy.

On the affirmative side of the ledger, elimination of the premium payment test creates an inviting means for insurance minded taxpayers to increase substantially their estates, free of estate tax. A taxpayer may by gift, in the absence of contemplation of death, and as long as he retains no incidents of ownership, transfer policies on his life, or on the life of any family member, to members of the family, pay the premiums, or continue to pay the premiums, and upon taxpayer's death, the insurance proceeds will be excluded from his taxable estate.

Where the taxpayer dies after August 16, 1954, regardless of whether he has previously paid part or all of the premiums, the insurance proceeds will not be taxable in his estate, provided he has previously transferred ownership and such transfer is not in contemplation of death. Therefore, taxpayer may create an insurance estate, tax-free, using old as well as new policies.

In making such gifts, taxpayer has the advantage of not only paying lower gift tax rates, but of also utilizing the new liberal rules applicable to the annual exclusion. (See discussion under Section 2503.) By combining the new law applicable to the elimination of the premium payment test and the annual exclusion in gifts to minors, taxpayer may substantially increase his estate free of gift and estate tax.[64]

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[62] The following examples will illustrate instances where taxpayer will have less than 5% reversionary interest (*the Actuaries Table of* 4% is used since no other specific actuarial table has yet been designated): 1) if the owner is the only beneficiary and is age 10 or under, the insured must be at least age 71; 2) if the owner is age 35 or older and is the beneficiary together with another whose age is 10 or under, the insured must be at least age 45; 3) if there are two owners who are also the only beneficiaries and are age 10 and 12, or under, respectively, then the insured must be at least age 34.

[63] See comments Sen. Hr., pp. 579, 1567. For further drafting criticism see Sen. Hr., pp. 206, 207 and compare with the comment Sen. Rep., p. 473.

12. Life Insurance Annuity Payments with Power of Appointment in Surviving Spouse

SECTION 2056(6) (formerly Section 812(e))

Purpose. To continue the marital deduction treatment under prior law and to broaden its coverage.

Prior law. Under prior law, the proceeds of insurance, endowment or annuity contracts may qualify if the following conditions are satisfied:

1. the proceeds must be held by the insurer subject to an agreement either to pay the proceeds in installments or to pay interest thereon (whether the proceeds, on the termination of any interest payments, are payable in a lump sum or otherwise), with *all* such amounts payable during the life of the surviving spouse, payable only to her; and
2. such installments, or interest, must be payable annually or semi-annually commencing not later than 13 months after the decedent's death; and
3. the surviving spouse must have the power, exercisable in favor of herself or her estate, to appoint *all* amounts so held; and
4. any such amounts payable under such contract must not be subject to a power in any other person to appoint any part thereof to any person other than the surviving spouse.[65]

New law. This provision is in substance identical with prior law, with a single change. There is a modification in that the requirement for insurance proceeds to qualify for the marital deduction, the surviving spouse's rights to the proceeds during her life and her general power of appointment must apply to *all* of the proceeds. The new law specifically authorizes this deduction where the surviving spouse's marital deduction rights apply to "all or a specific portion" of the insurance proceeds. Where the surviving spouse's marital deduction rights are limited to a specific portion of the insurance proceeds, the deduction is likewise limited to that portion.

Comment. Under prior law, insurance proceeds qualifying for the marital deduction were segregated from non-qualifying proceeds by the expediency of dividing a policy into separate funds. Presumably, the necessity of segregating funds qualifying for the marital deduction has been eliminated. Unanswered is the question of how the specific portion qualifying for the marital deduction must be treated in relationship to the other non-qualifying proceeds of any policy. Unless clarified by the regulations, the prior practice of separating policies will probably continue.

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[64] Research Institute of America's "Guide to the New Internal Revenue Code," p. 46 observes that this change in law will have the following effects:

> ". . . In order to pass proceeds to children free of estate tax, it is no longer necessary to have the premiums paid by a person other than the insured. For example, insurance on a husband's life need no longer be taken out by his wife. . . . Proceeds payable to a wife under a policy paid for by the husband on his own life need no longer qualify for the marital deduction. This frees the full marital deduction for use in non-insurance assets to the wife. . . . Insurance trusts may be arranged so that the policy proceeds are not taxed in the grantor's estate. The fact that premiums are paid with income from property held by the trust won't render the proceeds subject to estate tax. . . . Insurance bought by an employer on the life of its employee will not be included in the employee's estate solely because he is considered to have indirectly paid the premiums through receipt of compensation."

For recent analysis of possible tax savings see *Journal of Taxation*, Vol. I, p. 31 (July 1954).

[65] Proceeds payable in a single sum to the surviving spouse or to the estate of the surviving spouse automatically qualify for marital deduction under Section 2056(a) formerly Section 812(e)(1)(A) IRC 1939.

13. Liability of Life Insurance Beneficiaries

SECTION 2206 (formerly Section 826(c))

Purpose. To provide, unless decedent's will directs otherwise, for a contribution to decedent's estate tax by certain life insurance beneficiaries.

Prior and new law. This section incorporates prior law without substantive change. It provides, in the absence of a contrary intention in the decedent's will, that if any part of the gross estate on which the tax is paid includes insurance on the decedent's life passing to a beneficiary other than the executor, the executor is entitled to recover from such beneficiary such portion of the total estate tax as the proceeds of the policy bear to the sum of the taxable estate, determined under Section 2051.

Where the insurance proceeds are receivable by the surviving spouse and such proceeds are not greater than the marital deduction allowed to the estate, the surviving spouse is not liable to make any such contribution. The executor is entitled to recover from the surviving spouse a proportionate contribution only on the excess over the marital deduction.

Comment. A special problem existing under prior law remains unsolved. Where an installment or interest option has been elected and neither decedent's will nor local law provides for the apportionment of estate tax, to what extent are beneficiaries of life insurance policies liable for the estate tax paid? Applying the statute, the executor would be entitled to recover from each beneficiary his proportionate share of the tax paid. A problem exists because the tax is based on the proceeds which the beneficiary has not yet received.[66]

14. Taxable Gifts

SECTION 2503 (formerly Section 1003)

Purpose. To retain prior law allowing the $3,000 annual exclusion for gifts of a present interest in property to any person, and to provide that certain gifts to minors be subject to this annual exclusion.

Prior law. Under prior law, the first $3,000 of gifts, other than gifts of future interests, made to any person during any calendar year, are excluded in determining taxable gifts.[67]

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[66] Sen. Hr., p. 268.

[67] A donor may make as many gifts (such as insurance policies on the donor's, or the donee's, or some other family member's life, or payment of premiums on a policy owned by the donee), up to $3,000.00 to any individual, free of gift tax, if each such gift is a present interest in

The term "future interest" may be defined as being an interest in property, the possession and enjoyment of which commences some time in the future as distinguished from a "present interest" in which there is an immediate and present right to such dominion.

The most natural objects of a donor's bounty are children and grandchildren, and the most natural method of making any gift, where such donees are minors, is in trust or to a guardian for the minor's benefit. For all practical purposes, this type of gift, under prior law, is a future interest and the annual exclusion of $3,000 is not available.[68]

New law. Availability of the $3,000 annual exclusion for gifts of a present interest to any person is retained. However, the definition of a present interest is broadened to indicate that a transfer to any person of a present interest in property shall remain a present interest, even though there is a possibility that such interest may be diminished by the exercise of a power of appointment, provided that no part of such interest will at any time pass to any other person.[69]

Example: D, the donor, conveys $5,000 to T, the trustee, in trust, to pay the income to A, son of the donor, for life, the remainder to B, A's son. T has the uncontrolled power to terminate the trust and pay over to A the trust principal, in whole or in part, and at any time. A's present right to income may only terminate or diminish upon his receiving a greater interest in the trust res. No person,

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property; e.g., A gives during the calendar year 1953, cash or property as follows: $1,000 to B, $2,000 to C, $3,000 to D and $4,000 to E. The donees are entitled to unrestricted present enjoyment. Only $1,000 is subject to tax. This tax is computed on the aggregate taxable gifts since June 6, 1932, as provided in Section 1003(a), IRC 1939. Any gift in excess of the annual exclusion may be subject to certain deductions such as a gift to a charity or to a spouse. In addition thereto, United States citizens and residents are entitled to a lifetime gift tax exemption of $30,000.00. All gifts of future interests or gifts of present interests in excess of the annual $3,000 exclusion may be applied against this lifetime exemption. The taxpayer may utilize this exemption at such times and in such amounts as he may desire. Where a spouse joins in making a gift, there is a $6,000.00 annual exclusion as to each person and, of course, a combined $60,000.00 lifetime exemption. The fact that the policy matures at some uncertain future time does not by itself create a future interest; and the interest is a present interest if the donee has a right to the cash surrender value, policy dividends and the other rights that are then capable of immediate enjoyment.

[68] H. Rep., p. 93, Sen. Rep., p. 127 summarize the taxpayer's difficulty under existing law, as follows: "Doubt arises as to whether a gift in trust for a minor can be a present interest since the child does not presently have complete control over the property. Where a child's guardian who has control over gifts to a child, is personally responsible for the support of a child, since he must provide for the current needs of the child, it would appear that a valid gift could only be for a child's future benefit." The attitude of the Internal Revenue Service has been that all gifts to minors in trust are gifts of future interest, and taxpayer victories have been limited to situations with little general applicability.

[69] Sen. Rep., p. 478; Section 2503(b) as it appeared in the House bill corresponded in substance to Section 1103(b) IRC 1939. The Senate revised this provision, explaining Sen. Rep., p. 127 "sometimes a present interest in property, such as a life estate, is coupled with a future interest, such as the power of a trustee to terminate a trust and make immediate distribution to the life tenant. Under present law, the life estate might be held to have no value since the future interest could result in its immediate termination although such termination would increase rather than diminish the value of the gift to the donee." The Senate, approved by the Conference Committee, added the following sentence to Section 2503(b): "Where there has been a transfer to any person of a present interest in property, the possibility that such interest may be diminished by the exercise of a power should be disregarded in applying this sub-section, if no part of such interest will at any time pass to any other person." Conf. Rep., Amendment No. 277, p. 75.

other than A, during A's lifetime, has the right to receive the income or principal. Under the provision of 2503(b), A's present right to income is treated as a gift of a present interest.

This section also introduces an entirely new provision. A gift to a minor will be a present interest and subject to the $3,000 gift tax exclusion, if: (1) the income and principal may be used by or on behalf of a minor until he reaches age 21; and (2) any amounts not so used pass to the minor when he reaches age 21, or in the event of his death prior thereto, to his estate, or as he may appoint under general power of appointment.[70] This provision is effective only as to gifts made on or after January 1, 1955.

Comment. By permitting gifts in trust to minors to be gifts of present interests, while eliminating the premium payment test of ownership, the 1954 Revenue Code has introduced a dynamic formula for tax-free insurance planning. Insurance estates may be created for minor members of the family group, free of estate and gift taxes. The gift of an insurance policy, or the payment of premiums, may be subject to the annual exclusion. The valuation of the policies may be excluded from the donor's estate.

Example: A father creates an insurance trust for his minor son. The insurance policy is on the father's, son's or other family member's life. The gift of the policy may be made in trust and still be subject to the annual exclusion provided that the trust terminates when the son reaches the age of 21, and the other requirements of Section 2503 are satisfied. The donor may continue to pay the premiums and as long as he retains no incidents of ownership, or any reversionary interest greater than 5 per cent, as considered in the discussion of Section 2042, the premiums up to $3,000 will be subject to the annual exclusion, and none of the value of the equities created in the insurance policies donated will be in the donor's estate. Further, the mother, by joining in such gift, doubles the annual exclusion available, thereby substantially increasing the ultimate gift and estate tax-free insurance estate.

15. Conclusion

No other phase of the tax law has been more comprehensively revised than the provision affecting life insurance company contracts. While the taxpayer, for the most part, has benefited, any intelligent insurance planning requires caution. At the time of preparation of this article, most of the applicable regulations have not yet been issued. Moreover, immediate legislative changes are in the offing. This new look at the tax law affecting life insurance and annuities perhaps epitomizes the view of the general practitioner as to all tax law—*he is never quite sure of what he sees, and what he does see may not be there the next time he looks.* •

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[70] The Senate approved by the Conference Committee revised Section 2503(c) deleting the requirement that principal or income be actually expended by or for the minor during minority and in lieu thereof providing that such amounts *may* be expended, provided that any amounts not so expended will pass to the donee upon his attaining age 21, or in the event of his prior death, would be payable to his estate or as he may appoint under general power of appointment. The House bill required that this power of appointment be exercisable only by will. The Senate eased this restriction so that both testamentary and inter vivos forms of appointment would be effective. Sen. Rep., p. 479, Conf. Rep., Amendment No. 277, p. 75.

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Part V

BUSINESS MANAGEMENT PROBLEMS

39

How to Handle Sales Between Controlled Companies or Other Related Taxpayers to Avoid Loss Disallowance

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For many years, the corporation has been one of the more important fictions in the business world. Generally, the income tax law accords full significance to this fiction, treating the artificially-created corporate entity as if it were a real person, distinct from its subsidiary corporations, its stockholders and their other corporations. There are instances, however, in which the corporate fiction and the facts of life unmistakably clash: The income tax law is apt to be realistic in such instances, as when a taxpayer sells property to a related entity or related individual at a loss. The law may disallow the loss specifically (1954 IRC § 267; 1939 IRC § 24(b)), or may do so as a result of general principles requiring that the transaction be not an empty transfer of legal title, but a real sale, marking with finality the realization of an economic loss. The same problem as to allowance of loss arises upon transfers between husband and wife (or their companies) and between other taxpayers closely related by blood, by friendship, or by business or other interests, in fact wherever the relationship and circumstances are such as to suggest that the transferred property still may be under the domination and control of the seller, or that its fruits still may be enjoyed by him.

1. Points to Consider

In determining whether loss will be allowed on a sale between related taxpayers, Section 267 (formerly 24(b)) should be considered first. If its terms are applicable, the loss will be disallowed, and the study need go no further. If Section 267 is not applicable to the transaction, additional analysis is needed, since the loss may nevertheless be disallowed under general principles implicit in the Internal Revenue Code.

Finally, Sections 482 (formerly 45) and 269 (formerly 129) should be considered. Section 482, which authorizes the Commissioner to allocate losses within a controlled group but not to disallow the losses,[1] is the subject of a separate chapter in this book, as is Section 269. The latter provides in certain instances for the full or partial disallowance of a deduction, credit, or other allowance which a taxpayer attempts to enjoy through the acquisition, on or after October 8, 1940, of the control of a corporation or the property of a corporation, the principal purpose of the acquisition being evasion or avoidance of Federal income or excess profits tax by securing the benefit of the aforesaid deduction, credit, or other allowance.

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[1] *General Industries Corp.*, 35 B.T.A. 615 (1937); A. G. *Nelson Paper Co.* (1944), Par. 44,286 Prentice-Hall Memorandum T.C.

The problems peculiar to Section 267 are considered under the following headings:

Section
Transactions to which Section 267 applies 2
Definition of "members of a family" 3
Rules for determining ownership of stock in a corporation which is a party to a sale or exchange 4, 5, 6, 7
Meaning of "sale or exchange" 8
Indirect sales or exchanges 9
Transactions between partnership and controlled corporation 10
Separation of gains and losses in same transaction 11
Effect of good faith 12
Basis of property 13
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Problems falling outside Section 267 are considered under headings listed in Section 16 of this chapter.

2. Transactions to Which Section 267 Applies

Under this section, no deduction is allowed in respect to losses from sales or exchanges of property (other than distributions in corporate liquidation) directly or indirectly between:

Members of a family
The grantor and fiduciary of a trust
The fiduciaries of two trusts, if the same person is grantor of each
The fiduciary and beneficiary of the same trust or of another trust of which the same person is grantor
A corporation and the individual owning (directly or indirectly) more than 50 per cent in value of its outstanding stock
Two corporations, if the same individual owns (directly or indirectly) more than 50 per cent in value of the outstanding stock of each provided either corporation was a personal holding company for its preceding taxable year
The fiduciary of a trust and a corporation more than 50 per cent in value of the outstanding stock of which is owned (directly or indirectly) by or for the trust or a grantor thereof
A person and an exempt organization controlled by such person or his family

Section 267 is *inapplicable* to transactions between a stockholder and a corporation, or between two corporations in which the same individual holds stock, if the stockholder owns in each instance precisely 50 per cent[2] (or less) of the stock, subject to the stock ownership rules discussed in Section 4 of this chapter.

3. Members of a Family for Purposes of Section 267

Section 267(c)(4) (formerly 24(b)(2)(D)) states that the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. This list is important for two reasons: first, losses on sales or exchanges between "members of a family" are disallowed; second, an individual is considered as owning the stock owned, directly or indirectly, by or for his "family" (as well as by certain other persons), under the stock ownership rules discussed in the next section of this chapter.

The operation of Section 267 is not affected by the fact that the purchasing member of the family occupies a special tax category in respect to the property, such as the status of a dealer in securities.[3]

4. Rules for Determining Ownership of Stock in a Corporation That Is a Party to a Sale or Exchange

Section 267(c) prescribes the circumstances in which stock in a corporation, a party to a sale or exchange, is to be considered as owned by a person other than the actual owner.[4] These provisions are complex, and their application to individual cases should be carefully studied. Stock owned, directly or indirectly, by or for a corporation, partnership, estate or trust, is considered as being owned proportionately by or for its shareholders, partners or beneficiaries.[5] An individual, whether or not he himself owns any stock, is considered as owning stock owned by or for his family (directly or through their interests in corporations, partnerships, trusts or estates owning such stock); but such individual is not chargeable with stock deemed owned by his family members only by virtue of their own family connections with persons not themselves related to him (e.g., his son's wife or his own wife's father). An individual is also deemed to own stock owned directly or indirectly by his partner (whether or not as a partnership asset), but only if such individual himself owns some of the stock, directly or indirectly (disregarding family holdings, in the case of both the individual and his partner, but taking into account their indirect holdings through corporations, partnerships, trusts or estates). The rules may be illustrated as follows:

A owns 1 per cent of the stock of a corporation. His wife, son, father, grandfather, and partner each owns 10 per cent. A is considered as owning 51 per cent of the stock, and loss on a sale between A and the corporation will be disallowed.

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[2] See *Hewitt Rubber Co. of Pittsburgh* (1947), par. 47,317 Prentice-Hall Memorandum T.C.

[3] In *Claire S. Strauss* (1943), par. 43,217 Prentice-Hall Memorandum T.C., the taxpayer sold securities to her husband, a dealer in securities, claiming that his occupation made former § 24(b) (now § 267) inapplicable. The loss was disallowed.

[4] *Lewis L. Fawcett*, 3 T.C. 308 (1944), affirmed (2 Cir. 1945) 149 F. 2d 433, 33 AFTR 1387.

[5] The law and regulations afford no clue to whether a trust beneficiary's "proportionate" interest is to be determined by his share in the income or in the corpus, or by an actuarial valuation that takes both into account. If income shares control, what is the proportionate interest of one who is entitled to a variable amount of income after payment of a fixed annuity to others, or whose income share is dependent on the discretion of the trustee or another? If corpus shares control, how is a contingent remainder treated?

A owns none of the corporation's stock. His wife, son, father, grandfather and partner each owns 11 per cent. A is considered as owning only 44 per cent of the stock, the amount owned by his partner being ignored in these circumstances. Hence Section 267 is not applicable to a transaction between A and the corporation.

A individually owns none of X corporation's stock. He and an otherwise unrelated individual, however, own equally all the beneficial interests in another corporation, a partnership, an estate and a trust, each of which owns 20 per cent of the stock of X corporation. The remaining 20 per cent is owned by a member of A's family. A is considered as owning 60 per cent of X's stock (half of the stock owned by the partnership, estate, trust and the other corporation, and all of the stock owned by the member of A's family). The result would be the same if a partner of A instead of a member of A's family owned the remaining 20 per cent.

A owns 50 per cent of the stock of a corporation. His wife's father owns the other 50 per cent. Hence A's wife is considered as owning 100 per cent, but her husband and father are considered as owning only 50 per cent each.

A and his partner each owns 50 per cent of the stock of a corporation. Each is considered as owning more than 50 per cent (i.e., 100 per cent) and therefore Section 267 is applicable to transactions between A and the corporation, or between the partner and the corporation. The section is not applicable, however, to transactions between A and his partner, or between A's brother and the partner, or between A's brother and the corporation.[6]

It should be emphasized that the above rules properly apply only in determining whether the stock of a corporate party to a transaction is more than 50 per cent owned by or for one individual, for purposes of Section 267(b)(2) and (3) (formerly Section 24(b)(1)(B) and (C)). It has no application in determining *who* is the seller or the purchaser. A sale by or to a corporation must be judged by the provisions relating to corporate sales, and cannot be translated into a sale by or to its individual stockholders, for the purpose of applying one of the other provisions (e.g., making it a sale between members of a family).[7] Similarly, a sale by or to a fiduciary must be judged by the provisions relating to fiduciary sales, and may not be regarded as a sale by or to the individual beneficiaries. That is obviously true where the subject of the sale is property other than stock,[8] and it should be equally clear where corporate stock is sold.[9] Nevertheless, there is one decision which looks through the fiduciary and treats the beneficiaries as the sellers, where stock was the subject of the sale, and the Tax Court (though often deciding inconsistently with it) has never squarely overruled it.[10] The question must, therefore, be regarded as still unsettled.

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[6] Regulations 118, § 39.24(b)-1(d), Example (2).

[7] *John A. Snively*, Sr., 20 T.C. 136 (1953), on appeal to 5th Circuit.

[8] *John A. Snively, Sr.*, see footnote 7. The result of the *Snively* case, in allowing a loss on a sale by a corporation to a trust for the family of the corporation's principal stockholder, has been changed in the 1954 Code by the addition of a new category of sales on which losses are disallowed. But the principle of the decision remains valid, that the sale must be judged as a sale to or by the fiduciary and not to or by the beneficiaries.

[9] In *Lewis L. Fawcett*, see footnote 4, the Tax Court said: "Under the first three subparagraphs of paragraph (2) [Section 24(b)(2)(A), (B) and (C) of the 1939 Code; Section 267(c)(1), (2) and (3) of the 1954 Code]; the ownership of stock in a corporation, a party to the sale, is attributed to persons other than the actual owners under certain circumstances. These provisions have no reference to stock which is the subject of a sale or exchange."

In the case of a sale to or by a partnership, however, it is clear that the partnership is disregarded and the sale is regarded as one to or by the individual members.[11] That is not by virtue of the constructive ownership rules, however, but results from the fact that the partnership (unlike a corporation, trust or estate) is not treated as a distinct taxable entity.

5. Two Individuals Considered as Owning the Same Stock at the Same Time

In compliance with the stock ownership rules of Section 267, it has been held that each of two brothers who made separate purchases from a corporation was to be considered as owning the stock of the other and the stock of his father and his other brothers, in determining whether he was the owner of more than 50 per cent of the seller's outstanding stock.[12] The decision made it clear that two individuals may be considered as owning the same shares at the same time. However, stock which is merely constructively owned by one brother (by reason of ownership in his family) is not chargeable to the other brother unless the *actual* owners stand in the prescribed relationship to himself.[13]

6. Valuation of Corporate Stock

In the case of a sale or exchange between stockholder and corporation, or between two corporations, Section 267 becomes applicable if the stockholder owns (actually or constructively) stock whose value is more than the total value of the stock outstanding in the hands of all other persons. This test is also laid down in IRC Section 542(a)(2) (formerly 501(a)(2)) relating to personal holding companies, and in IRC Section 552(a)(2) (formerly 331(a)(2)), relating to foreign personal holding companies. Hence, decisions under each of these sections ultimately may be of aid in construing the foregoing language in Section 267.

The above-mentioned value aspect of former Section 24(b) (now 267) has been discussed in two cases. One taxpayer contended that former Section 24(b) could not apply in the particular case because all the outstanding stock was valueless, but the court was able to dispose of the case upon other grounds.[14] Another taxpayer, owning only preferred stock, might have avoided former Section 24(b) if he had been able to convince the court that the corporation had good will, enhancing the value of its common stock and sending down the value of the preferred.[15]

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[10] Estate of Charles C. Ingalls, 45 B.T.A. 787 (1941), affirmed (6 Cir. 1943) 132 F. 2d 862, 30 AFTR 699.

[11] *Commissioner* v. *Whitney* (2 Cir. 1948), 169 F. 2d 562, 37 AFTR 211, certiorari denied 335 U.S. 892 (1948), reversing 8 T.C. 1019 (1947); Rev. Rul. 121, 1953-2 C.B. 209. See section 10 of this chapter.

[12] *Hosch Brothers Co.*, 3 T.C. 279 (1944). See, also, *Tri-Borough Transportation Co.* (1946), par. 46,049 Prentice-Hall Memorandum T.C.

[13] 1954 IRC § 267(c)(5); 1939 IRC § 24(b)(2)(E); *Graves Brothers Co.*, 17 T.C. 1499 (1952) (Acq.).

[14] *Butler Consolidated Coal Co.*, 6 T.C. 183 (1946).

[15] *Wolf Bergman* (1947), par. 47,285 Prentice-Hall Memorandum T.C.

7. Time of Determining Stock Ownership

Complications arise when the corporate stock itself is the subject of the sale or exchange between corporation and stockholder. It has been held in such instances that the stock ownership rules apply as of the time when the contract of sale is made, thereby disallowing loss to a stockholder who is left with not more than 50 per cent of the stock when the transaction is completed,[16] or who is left with none of the stock.[17] On the other hand, if the 50 per cent control is lacking before but is acquired as a result of the transaction, that also satisfies the stock ownership rule of Section 267.[18]

8. Meaning of "Sale or Exchange"

The words "sale or exchange" as used in Section 267 are broad in scope. Hence they apply to many transactions which the unwary might not consider as being within the section.

In one case,[19] part of the estate of the taxpayer's father, consisting of securities and cash, was distributed to a joint account for the equal benefit of the taxpayer, his mother, and two sisters. Some years later, the taxpayer withdrew from the joint account, and received therefrom in cash an amount representing the value of his interest. This amount was less than his cost basis. The loss was disallowed, on the ground that his receipt of cash (in excess of one-fourth of the cash in the account) resulted from a "sale" to his mother and sisters of his share in the securities held in the account.

The foregoing result could have been avoided, of course, if the joint account had been terminated by distribution in kind to each of the members, followed by the taxpayer's sale of his securities to an outsider. Or the joint account could have been maintained, but all of its assets reduced to cash before the taxpayer's withdrawal.

The withdrawal from a partnership also may amount to a sale, loss from which is disallowed by Section 267.[20]

In the depression, a corporate taxpayer had funds on deposit in a closed bank. It knew in 1939 how much of the debt ultimately would be paid. Desiring to write off its loss in 1939, the taxpayer sold its claim at fair market value to its majority stockholder, who later received an equivalent amount from the liquidation of the bank. It was held that the taxpayer had completed a sale, loss upon which was disallowed by former Section 24(b).[21] A bad-debt deduction probably would have been available to the taxpayer in 1939, had it not set up the formal transaction with the majority stockholder.

Another transaction deemed to be a sale or exchange under former Section 24(b) was one in which a taxpayer, owner of a one-sixth undivided interest in unprofitable real estate, gave a quitclaim deed to his brother in return for the latter's assumption of all the taxpayer's liabilities in respect to the transferred property.[22]

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[16] W. A. *Drake*, 3 T.C. 33 (1944), affirmed (10 Cir. 1944) 145 F. 2d 365, 32 AFTR 1475.

[17] *Bernard Rubin* (1946), par. 46,075 Prentice-Hall Memorandum T.C.

[18] *Prentiss D. Moore*, 17 T.C. 1030 (1951), affirmed (5 Cir. 1953) 202 F. 2d 45.

[19] *Henry V. B. Smith*, 5 T.C. 323 (1945).

[20] *Nathan Blum*, 5 T.C. 702 (1945).

[21] *The M. Conley Co.* (1943), par. 43,008 Prentice-Hall Memorandum T.C.

The transfer of property in payment of, or for credit upon, a debt owed by the transferor, is a sale or exchange within the meaning of Section 267.[23] On the other hand, the Court of Claims, in a 3-2 decision,[24] held that the loss was not attributable to a sale or exchange where a son had purchased property from his mother with a condition that it should revert if he predeceased her; the loss of his investment at his death was allowed. The dissenters viewed the loss as resulting from the terms of the sale between mother and son, and declared that it should have been disallowed.

9. Sales or Exchanges Indirectly Between Related Entities or Individuals

The statutory language disallows losses from sales or exchanges of property directly or indirectly between certain persons. If Smith sells 100 shares of corporate stock to a dummy from whom Smith's wife buys the same shares, it is considered that there was a sale indirectly between Smith and his wife, and loss thereon is disallowed.[25] Suppose, however, that Smith sells his shares upon the stock exchange, and his wife buys upon the exchange a like number of shares in the same corporation. Under facts like these, the Tax Court held in the *McWilliams* case[26] that the husband did not sell to his wife but to an unknown purchaser. The circuit court reversed,[27] stating that the transaction was an indirect sale between members of a family, because at the end of the transaction the parties "were in the same position as if they had dealt directly with each other as buyer and seller," having transferred fungible property[28] from one to another at a substantially unchanged price and in accordance with a pre-existing design. The circuit court was upheld by the Supreme Court.[29] Its opinion is discussed in detail in Section 14-c of this chapter.

The Tax Court has held that there was a sale indirectly between members of a family where a husband bought from a bank certain stock owned by his wife and pledged by her nine years earlier, the sale being viewed as having been made under her authority.[30] The court reached the same conclusion as to a sheriff's sale of a farm to mortgagees, the taxpayer's brothers and sisters, who had brought foreclosure proceedings which the taxpayer unsuccessfully contested.[31] In a brief but pungent dissent, three judges pointed out that the sale was not made by the taxpayer but by the sheriff. The latter view has been adopted by the Seventh Circuit in allowing a loss on a tax sale of property to a corporation almost wholly owned by the former owner of the property.[32]

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[22] *Charles J. Stamler*, 45 B.T.A. 37 (1941). See H. E. Wood (1940), par. 40,613 Prentice-Hall Memorandum B.T.A.

[23] See the opinion of the circuit court in *Lakeside Irrigation Co.* v. *Commissioner*, see footnote 36, and *Stephenson Land Co.* (1946), par. 46,108 Prentice-Hall Memorandum T.C.

[24] *National Metropolitan Bank* v. *United States* (Ct. Cls. 1953), 111 F. Supp. 422.

[25] On the other hand, if a corporation is organized by Smith to accomplish a bona fide business purpose, and not for the purpose of accomplishing an indirect sale of the property to Smith's wife, the loss that Smith might subsequently suffer upon liquidation of the corporation would not be disallowed, even though the loss was due to a sale of the corporation's property to Smith's wife. See *John Randolph Hopkins*, 15 T.C. 160.

[26] 5 T.C. 623 (1945). Accord: *Pauline Ickelheimer*, 45 B.T.A. 478 (1941), affirmed (2 Cir. 1943) 132 F. 2d 660, 30 AFTR 652; and *August Kohn* (1945), par. 45,351 Prentice-Hall Memorandum T.C., reversed (4 Cir. 1946) 158 F. 2d 32, 35 AFTR 351.

[27] (6 Cir. 1946) 158 F. 2d 635, 35 AFTR 542.

[28] The circuit court's opinion included the following statement: "No material change was made in the property rights held by the broker for the taxpayers, for a certificate for the same number of shares, although printed upon different paper and bearing a different number, represents precisely the same kind and value of property as does another certificate for a like number of shares of stock in the same corporation. *Richardson* v. *Shaw*, 209 U.S. 365, 378; *Gorman* v. *Littlefield, Trustee*, 229 U.S. 19, 23."

[29] 331 U.S. 694, 35 AFTR 1184 (1947).

10. Transactions Between a Partnership and a Corporation Controlled by the Members of the Partnership

Closely related to the problem of sales or exchanges indirectly between related entities or individuals is the matter of a sale between a partnership and a corporation controlled by the members of the partnership. Section 267(b)(2) (formerly Section 24(b)(1)(B)) generally disallows loss on a sale or exchange between an individual and a corporation more than 50 per cent of the stock of which is owned by such individual. Does the term "individual" include a partnership? In the *Whitney* case,[33] the Tax Court indicated that it did not, but the Circuit Court of Appeals for the Second Circuit reversed the decision.[34]

The facts in the *Whitney* case were as follows: The thirteen members of a general banking partnership (J. P. Morgan & Co.) decided that their New York business should be incorporated as a trust company. The partnership sold assets, some at a gain and some at a loss, to a newly organized corporation (J. P. Morgan & Co., Incorporated), 78.2 per cent of the stock of which was owned by the partners and their relatives. If each individual member of the partnership had made the sale jointly with every other member, the loss would have been disallowed. The circuit court believed the result must be the same where the partnership made the sale. It considered that a differentiation between the aforesaid two sales was without "substance or reality" in view of the statutory method of treating partnerships for Federal income tax purposes and in the light of the legislative purpose of former Section 24(b).

11. Gains on Sales: Separation of Gains and Losses in the Same Transaction

The fact that losses from certain sales or exchanges would be disallowed by Section 267 does not serve to exempt from taxation any gains realized on such transactions.[35]

The Section, moreover, cannot be avoided by offsetting within a single transaction gains and losses on separate pieces of property. In a leading case, a corporation, at one time and in one transaction, sold to a stockholder, considered as owning more than 50 per cent of its stock, four blocks of securities at market prices which resulted in gains as to two of the blocks and losses as to the other two, there being a small net gain on the entire transaction. The Commissioner was upheld in treating the transfer of each block as a separate sale, with the result that the losses could not, by reason of Section 24(b), be used to offset the gains.[36] This conclusion has been reached in other stock sales cases,[37] as well as in a case involving the sale of real estate.[38] This principle cannot be avoided by purporting to sell each item at cost, thereby indirectly obtaining the benefit of the forbidden loss deduction through the avoidance of gain on the appreciated block.[39]

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[30] *Charles E. Cooney* (1942), par. 42,589 Prentice-Hall Memorandum T.C.
[31] *Thomas Zacek*, 8 T.C. 1056 (1947).
[32] *McCarty* v. *Cripe* (7 Cir. 1953), 201 F. 2d 679.
[33] *George Whitney*, 8 T.C. 1019 (1947).
[34] (2 Cir. 1948) 169 F. 2d 562, 37 AFTR 211, cert. den. 335 U.S. 892 (1948).
[35] I.T. 3334, 1939-2 C.B. 180.

It is true that the above-mentioned cases merely lay down a general rule, for the courts concede that there may be instances in which separate properties could be substantially integrated, so that their sale would be an indivisible transaction. These instances, however, appear to be rare. The clearest case, of course, would be one of physical integration, as where bricks, lumber and other materials are bought separately and made into a building.[40] Yet, since the gain or loss on a building is computed separately from the gain or loss on the land on which it stands, even if they were bought and sold as a unit,[41] gain on the land might be taxed even though an unallowable loss was sustained on the building, or vice versa. Likewise, the fact that two buildings, separately purchased, are integrated in use, does not permit the gain on one to be offset against the disallowed loss on the other.[42] Integration would very rarely be found to exist in the case of stock or bond investments,[43] or of other properties not forming a single physical unit.[44]

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[36] *Lakeside Irrigation Co.*, 41 B.T.A. 892 (1940), affirmed (5 Cir. 1942) 128 F. 2d 418, 29 AFTR 521, cert. den. 317 U.S. 666 (1942).

[37] *M. F. Reddington, Inc.* (1942), par. 42,101 Prentice-Hall Memorandum B.T.A., affirmed (2 Cir. 1942) 131 F. 2d 1014, 30 AFTR 515; *B. O. Mahaffey*, 1 T.C. 176 (1942), reversed on another point (8 Cir. 1944), 140 F. 2d 879, 32 AFTR 185; *W. A. Drake, Inc.*, see footnote 16; *Morris Investment Corp.*, 5 T.C. 583 (1945), affirmed (3 Cir. 1946) 156 F. 2d 748, 35 AFTR 32, cert, den. 329 U.S. 788 (1946); *Ernest Ingold* (1951), par. 51,222 Prentice-Hall Memorandum T.C. See, also, I.T. 3334, see footnote 35.

[38] *William F. Krahl*, 9 T.C. 862 (1947).

[39] *Jacob M. Kaplan*, 21 T.C. 136 (1953), on appeal to 2d Cir.

[40] See *Lakeside Irrigation Co.* (5 Cir. 1942) 128 F. 2d 418, 419, 29 AFTR 521, 522, cert. den. 317 U.S. 666 (1942).

[41] *Constitution Publishing Co.*, 20 T.C. 1028 (1953).

[42] In *Krahl*, footnote 38, it was held that there had been no integration although (1) the taxpayer had purchased the second piece of real property to protect the first piece against physical damage; (2) ownership of the two pieces would have permitted him to replace the existing buildings with one fronting on two streets; and (3) the aggregate sale value of the two properties was greater if sold as a unit than if sold separately. Cf. *John J. Harden*, 21 T.C. No. 87 (1954); but cf. *Harden* v. *Hinds* (D.C. Okla. W.D. 1954), 1954 Prentice-Hall Fed. Tax. Serv., par. 72,539.

[43] Cf. *De Coppet* v. *Helvering* (2 Cir. 1940), 108 F. 2d 787, cert. den. 310 U.S. 646 (1940) (no separate loss allowable with respect to stock of investment affiliate of bank, where stock of affiliate could not be bought or sold except as a unit with bank stock).

[44] In the previous edition of this work, we suggested that integration might be found to exist where two separately acquired pieces of land are consolidated by the erection of a building partly upon each; or where a set of matched goblets, tapestries or other items have an aggregate status and value distinct from their separately-acquired components; or where the buyer, with business justification, refused except upon a lump sum basis to purchase or even to bid for certain assets, whose separate market value could not be satisfactorily determined. The recent decision (see footnote 41) requiring separation of the gain or loss computation as between land and building (even though § 267 or former § 24(b) was not involved) raises doubt that the integration rule would ever be applied where it is possible to determine a realistic separate value for the components.

12. Bona Fide Character of Transaction Under Section 267

The presence of good faith and a fair consideration will not prevent the application of Section 267,[45] for the section is constructed upon the irrebuttable premise that sales or exchanges between the statutorily described persons do not result in true economic loss.[46]

13. Basis of Property Following Loss Disallowance Under Section 267

The loss disallowance under former Section 24(b) was permanent, not temporary, for the purchaser took the property at his cost, there being no provision for carry-over of the seller's basis.[47] Nor could the parties rescind the transaction and thereby revest the old basis, if the sale originally was in good faith.[48]

That inequity is at least partially rectified in section 267(d) of the 1954 Code. There still is no carry-over of basis, for the purpose of allowing depreciation at the seller's rate or of allowing the purchaser to deduct, on a subsequent sale, the loss which had been denied to the seller. But the purchaser will not be taxed on a *gain* on his subsequent disposition of the property (after December 31, 1953), to the extent that the gain is offset by the loss which had been disallowed to the seller, under either Section 267 or its predecessor Section 24(b).[49] Where the property is divisible, and a part of it is disposed of by the purchaser, only an allocable part of the previously disallowed loss may be offset against the gain on such partial disposition.[50] If the purchaser exchanges the purchased property for other property in a transaction whereby the basis of the new property depends on that of the original property, the privilege of offsetting the disallowed loss continues. But a donee or other successor in interest of the original purchaser may not avail of the privilege.

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[45] See *Nathan Blum*, footnote 20, above; *Arizona Publishing Co.*, 9 T.C. 85 (1947); *Claire S. Strauss*, see footnote 3; *Thomas Zacek*, see footnote 31; *Lakeside Irrigation Co.*, see footnote 36; *M. F. Reddington, Inc.*, see footnote 37; *Henry V. B. Smith*, see footnote 19; *Charles J. Stamler*, see footnote 22; *M. Conley Co.*, see footnote 21. In one case, *Jordan C. Skinner* (47 B.T.A. 624 (1942)), the amount received by the seller from his brother was almost twice as much as that offered by anyone else.

[46] *McWilliams* v. *Commissioner*, see footnote 29.

[47] In this respect, former § 24(b) was harsher than the wash sales provision (§ 118). See 1939 IRC § 113(a)(10); 1954 IRC § 1091(d).

[48] *Herberich, Hall, Harter Agency, Inc.* (1944), par. 44,146 Prentice-Hall Memorandum T.C. If, under principles discussed later in this chapter, a loss is disallowed because the transfer is deemed a sham, one would expect it to be considered a sham for all purposes, so that the taxpayer could re-establish his original basis by reversing the transaction. See *Thal* v. *Commissioner* (6 Cir. 1944), 142 F. 2d 874, 32 AFTR 759. However, if a transfer is deemed a sham because the taxpayer does not thereby realize loss in economic fact, although he does in form, the taxpayer may find himself bound by the form of his transaction. *Higgins* v. *Smith*, 308 U.S. 473, 477, 23 AFTR 800 (1940).

See Robert H. Montgomery, Conrad B. Taylor, and Mark E. Richardson, *Montgomery's Federal Taxes—Corporations and Partnerships*, 1951-52, Vol. I, page 825. New York: Ronald Press Co., 1952.

[49] Since the reference in the statute is to Section 24(b) of the 1939 Code, no relief is granted if the property was acquired before 1939 from a related taxpayer whose loss was disallowed under corresponding provisions of earlier Revenue Acts.

[50] In general, the disallowed loss is allocated among the parts of the property in proportion to their market values on the date of the sale on which loss was disallowed; but if the part of the property has an ascertainable separate basis, that is used, and only the sale price is allocated in proportion to values, in determining the loss attributable to such part. H. Rep. No. 1337, 83d Cong., 2d Sess. p. A66.

In some cases, a loss would be disallowed under both Section 267 and Section 1091 (formerly 118), relating to wash sales. Suppose A holds stock which had cost him $200, sells it to his wife for $100, and replaces it on the market at the same price within 30 days. The loss is disallowed under both the cited sections. By virtue of Section 1091(d), A's basis for his new stock is $200. In order to prevent a double benefit, Section 267(d) is made inapplicable in such a case. Otherwise, if the price returned to $200, the husband and wife could sell for an aggregate of $400 and neither would realize a gain, although their total investment was only $300.

14. Methods of Avoiding Section 267 Penalty

a. In general. As already indicated, the bona fide character of a transaction affords no immunity against Section 267, for this section contains a rigid statutory formula. Because of such formula, avoidance is both "easy" and "impossible" of accomplishment, depending upon what one means by avoidance. For example, a sale to an outsider will avoid the Section 267 penalty, that is, loss disallowance. This sale, however, does not avoid but actually complies with the statutory mandate. The mandate is that a sale to an outsider is free of the section, the identity of such a buyer being accepted for purposes of the section as the proof of the seller's economic loss.

Regardless of rhetoric, it is clear that the seller will not be concerned with Section 267 if sales at a loss are made to outsiders and only sales at a gain are made within the related group of taxpayers.

Means of avoiding Section 267 penalty in several specific types of transactions also have been suggested in preceding sections of this chapter. The following paragraphs contain suggestions as to other possible steps.

b. Sales of property to certain relatives. Without risk of loss disallowance under Section 267, property may be sold to a relative who is not a brother, sister, spouse, ancestor, or lineal descendant of the seller. If, moreover, the sale is otherwise in good faith and for adequate consideration, any loss thereon will be allowed as well under the general principles discussed in the succeeding sections of this chapter.

A son-in-law (or daughter-in-law) of an individual is not his lineal descendant and is not otherwise within the family definition in Section 267.[51] A loss on a sale to one's wife's relatives is free of the restriction of Section 267 even if the loss is claimed on a joint return with the wife.[52]

Care must be taken, however, to insure in the case of a sale to a son-in-law or daughter-in-law that the transaction is neither in substance nor in law a sale to the seller's descendant. If the seller's daughter or son becomes a joint tenant or tenant by the entirety, even if the consideration originated with the spouse who is unrelated to the seller, the entire loss may be denied. In the *Stern* case, one of the prevailing opinions held that, since husband and wife each own the whole, in the theory of the law, the entire loss is incurred on a sale to the party who is related to the seller.[53] A strong dissent, however, held that the sale was made to the one who furnished the consideration, and that the other spouse (except to the extent that the consideration may have originated with him or her) took as donee from his or her spouse and not as purchaser from the person claiming the loss.[54] If, under local law, the conveyance creates a tenancy in common between the seller's child and his or her spouse, only half the loss is disallowed under Section 267.[55]

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[51] *Fervel Topek,* 9 T.C. 763 (1947).

[52] *J. Henry De Boer,* 16 T.C. 662 (1951), aff'd (2d Cir. 1952) 194 F. 2d 289.

The Tax Court extended the foregoing reasoning to a case involving community property in *Arizona Publishing Co.*[56] There the taxpayer corporation sold real property to X, who with his wife owned, as community property, 27 per cent of the corporation's stock. X's sister and her husband owned, as community property, 54 per cent of the corporation's stock. Since X paid the purchase price of the real property out of community funds, the property was deemed to have been sold to X and his wife as community property. Pointing out that under Arizona law a wife's title in community property is the equal of the husband's, the court held that loss was disallowed as to the portion of the property (one-half) sold to X, because he actually owned 13½ per cent of the corporate stock, and constructively owned his wife's 13½ per cent and his sister's 27 per cent, or a total of 54 per cent. The portion of the loss attributable to the property sold to X's wife was allowed (the price having been found to be fair), because her actual and constructive stock ownership included only the stock actually owned by her (13½ per cent) and that actually owned by her husband (13½ per cent).

A variation of the son-in-law transaction occurred in the *Saul* case.[57] Walter Saul gave to his daughters money that their husbands used to buy stock. The seller was Walter's brother. On these facts, the Revenue Service asserted that the result was the same as if the stock had been sold to Walter, who thereafter had given it to his sons-in-law. The Tax Court held that the sale was not between brothers, but between a seller and his brother's sons-in-law, who were not members of the seller's family. The Tax Court said:

> We cannot agree with the respondent that the sale was in effect a sale to the petitioner's brother. There is no showing that the purchasers did not acquire full title or that they held the stock for the benefit of Walter Saul. If the result intended by all the parties was to place the stock in the hands of the sons-in-law of the petitioner's brother the parties had the right to choose the method actually adopted, a gift of the funds by Walter Saul to his daughters followed by the purchase of the stock by their husbands, in preference to the alternative method of a purchase by Walter Saul of the stock followed by a gift of the stock. This is not a case of doing indirectly what the parties cannot, without foregoing the deduction, do directly, but merely a choice between two alternative methods

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[53] *Julius Long Stern*, 21 T.C. 155 (1953), on appeal to 3d Cir.

[54] Actually only five judges of the majority approved the application of former section 24(b) in these circumstances, and four concurred for other reasons not here relevant. Six judges dissented on the grounds stated in the text, and another dissented without opinion.

[55] *Walter Simister, Jr.*, 4 T.C. 470 (1944).

[56] See footnote 45. A similar result, under the law of Washington State, was reached in Rev. Rul. 121, 1953-2 C.B. 209.

[57] (1947) par. 47,178 Prentice-Hall Memorandum T.C.

of accomplishing the same end. That they choose the method which results in a tax saving is their privilege. There is nothing inherently wrong in such a choice.

Similarly, the brother-in-law or sister-in-law of an individual is not a member of his family under Section 267.[58] In a claimed sale to a brother's wife, however, it was found that she was merely the nominal purchaser, her husband (the seller's brother) being the real buyer.[59]

An individual also may deal with his uncles, aunts, nephews, and cousins, without Section 267 penalty.[60]

c. Sales and purchases upon the stock exchange. The *McWilliams* decision[61] effectively stopped avoidance of former Section 24(b) through prearranged stock exchange purchases and sales within a group of related individuals or entities. There is some danger, however, that revenue agents may attempt to invoke Section 267 penalty by extending this decision to cases involving materially different facts. Hence rather close scrutiny of the court's opinion is desirable.[62]

In general, losses from sales within the groups designated in Section 267 are disallowed because Congress thought that these sales did not actually terminate the investment. Although in the *McWilliams* case the members of the group sold to, and bought from, unknown persons, and stock certificates were received different from those sold, former Section 24(b) was held applicable because it was prearranged that the respective members of the group would buy and sell identical property. The prearrangement was clear on the basis of the following facts: the properties of the several members of the group were managed by one of them; orders to buy and sell were issued simultaneously, and were issued to the same broker; the orders were to buy at as close to the sales price as possible; the sale and purchase were promptly consummated, each on the same day; the amount of money received by the selling member of the group and that paid by the purchasing member differed only in the amount of broker's commissions and excise taxes; the transactions were part of a pattern which the group had followed on a number of occasions; the broker was advised that the purpose of transactions was to establish tax loss.

Several of the listed prearrangement factors have only corroborative significance. These include the factor as to a pattern of similar transactions, and the disclosure as to tax motivation. Other factors, including single management of the transactions, were essential to this particular kind of prearrangement, but in some instances prearrangement might be proven by showing a tacit understanding among the members of the group. Prearrangement likewise was implicit in the employment of a single broker, and in the specific orders given him as to price. The use of separate brokers, however, would not alter the situation, if other essential elements of prearrangement were present. It is believed, in other words, that in regard to the aforementioned factors at least, the courts probably will not closely limit the *McWilliams* doctrine to the precise facts of such case.

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[58] *Mauritz* v. *Scofield* (D.C. Tex. 1952), — F. Supp. —, 1952-5 Prentice-Hall Fed. Tax Serv. par. 72,428, aff'd on another issue (5 Cir. 1953), 206 F. 2d 135.

[59] *O. Phil Nordling* (1947), par. 47,046 Prentice-Hall Memorandum T.C., affirmed (9 Cir. 1948) 166 F. 2d 703, 36 AFTR 837, cert. den. 335 U.S. 817 (1948). To the same effect is *Charles J. Stamler*, see footnote 22.

[60] *Mauritz* v. *Scofield*, see footnote 58 (trusts for nephews).

[61] See footnote 29.

[62] The text discussion of the McWilliams decision closely follows the thoughts expressed by this writer in *Review of Supreme Court's Tax Decisions, 1946-1947 Term, Part 29 of Practical Aspects of Federal Taxation* (Bureau of National Affairs), pages 16-24; and *Implications of the McWilliams Case, Proceedings of New York University Sixth Annual Institute on Federal Taxation,* pages 1134-1139. New York: Matthew Bender and Company, 1948.

Other elements, such as the time factor, are of more than casual significance. The orders to buy and to sell were simultaneously issued, and were executed on the same day. It is clear, however, that the courts will not restrict the *McWilliams* principle precisely to these facts.[63] Suppose, on the other hand, that a full 30-day interval elapsed between the sale by one member of the group and the purchase by another. It might be argued that in such circumstances the loss should be allowed, since the seller would be allowed the loss if he repurchased after 30 days. If Section 267 were complementary to Section 1091 (formerly 118) (the wash sales provision), the loss would be allowed. Technically, however, the aforesaid sections are independent. Hence, it is concluded only that, if Congress had studied this in detail, it might have said that 30 days as effectively breaks the continuity of the investment, when a group is involved, as when one person is involved, and that therefore, as a practical matter, the deduction should be allowed in the hypothetical case. In a marginal note, the court refused to express any views as to such case involving a time interval of 30 days or longer.

It is difficult to say that one member of the group sold to another unless the consideration paid by the one and that received by the other is approximately the same. The price difference which will permit the group to escape Section 267 is difficult to compute by any general yardstick, just as is the time interval. Interpretative color will be lent each of these vital elements by the other factors present and by the general background of the transaction.

Doubtless the Revenue Service will assume that prearrangement was present in every transaction in which one member of a group buys property at or near the date and at or near the price at which like property is sold by another member. It should be possible to destroy this assumption by establishing that when the first member of the group bought or sold the other member did not intend to take converse action, and thereafter did so independently of the first member, and perhaps only in the light of later events, such as a change in economic or business circumstances. It is doubtful that the courts will sanction the disallowance of losses in transactions which are actually free from prearrangement. The issue is factual, and it may be assumed that the Tax Court will not be overly sympathetic with attempted extensions of the *McWilliams* doctrine.[64]

d. Stock transfers prior to sale of the property in question. Section 267 problems in connection with sales between an individual and his controlled corporation, or between two controlled corporations, may in some instances be eliminated by antecedent transfers of stock. The corporate stock ownership may be such that, prior to the stockholder's sale of property to the corporation or the sale of its property to him (or the sale by one corporation to another), the stockholder may be willing to enter into a bona fide sale to an outsider or to a relative not listed in Section 267(c)(4), or to have redeemed, enough of his stock to bring to 50 per cent or less the amount which he is considered as owning. This might be accomplished by bona fide gift as well as by sale.

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[63] This is indicated by the Supreme Court's statement as to why it granted certiorari. It said it did so because the decisions of the circuit courts in *McWilliams* and *Kohn*, see footnote 26, conflicted with those in *Ickelheimer*, see footnote 26. In both the latter cases, the sale by one member of the group and the purchase by another occurred on successive days.

[64] This conclusion is based upon the Tax Court's decisions originally favorable to the taxpayer in this field, and also by the reasoning in its memorandum decision in the *Saul* case (see footnote 57), handed down after the Supreme Court decision in *McWilliams*.

e. Sales between corporations. Regardless of common control, sales between two corporations are free of Section 267 if neither corporation was a personal holding company (including a foreign personal holding company) in its preceding taxable year. The status or non-status of such a company on the date of the sale or exchange is irrelevant.[65] It will in certain cases be desirable, and even necessary, to delay the sale, in order that proper steps may be taken to insure that neither corporation has personal holding company status for the year preceding the sale.

f. Sale by or to an estate. Section 267 disallows losses on sales or exchanges between a corporation and either an individual or a trust owning, directly or indirectly, more than 50 per cent of the corporation's stock.[66] An estate, however, is neither an individual nor a trust, so there appears to be no restriction on the deduction of losses on sales between an estate and a corporation in which the estate holds a majority of the stock.[67] However, if the subject matter of the sale is corporate stock and if, looking through the estate to its beneficiaries, there is more than 50 per cent ownership of stock in persons who are members of one family within the meaning of the statute, there is a possibility that the loss would be disallowed, under the questionable language of a decision discussed in section 4 of this chapter, which would deem the beneficiaries to be the sellers or purchasers for this purpose.[68]

g. Partial liquidation of a corporation. Where the property transferred to a corporation is its own stock, special circumstances exist. May loss disallowance be avoided in this case by consummating the transaction as a stock redemption in partial liquidation of the corporation? There have been no decisions on this point.[69] The statutory provision, it should be noted, excepts losses in the case of distributions in corporate liquidations.[70] Under 1954 IRC Section 331 (former 115(c)), distributions in liquidation may be in complete or partial liquidation of a corporation. Hence, the exception in Section 267 appears broad enough to cover partial liquidations. It is important, of course, that the redemption of stock fit the statutory definition of partial liquidation[71] and avoid classification as essentially equivalent to a dividend.[72] Such matters are discussed in a separate chapter of this book.

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[65] See Reg. 118, § 39.24(b)-1(b).

[66] In the case of a sale by or to a trust, the stock ownership of its grantor (direct and indirect through his family, etc.) is counted along with that of the trust.

[67] *Cf. John A. Snively, Sr.*, see footnote 7. The *Snively* case held that a *trust* was not an individual for this purpose, but the same would apply to an estate. The 1954 Code, Section 267(b)(8), overcame the result of the *Snively* case, with respect to trusts, but placed no restriction on sales to or by estates. The fact that trusts and estates, although often treated together for tax purposes, are always separately mentioned where both are intended to be covered (e.g., in Section 267(c)(1)), signifies that the new provision was not intended to apply to estates, when only trusts were mentioned.

[68] See footnote 10.

[69] In the *Rubin* case, footnote 17, the Tax Court mentioned that no claim had been made that the sale of its stock to a corporation effected a liquidation of the corporation.

[70] See *John Randolph Hopkins*, 15 T.C. 160 (1950). Under the 1939 Code, which excepted "distributions in liquidation," it was argued unsuccessfully that a loss on the liquidation of a *partnership* was free of the restriction on losses. *Commissioner* v. *Whitney*, see footnote 34. The matter is put beyond controversy by Section 267(a)(1) of the 1954 Code, which confines the exception to "distributions in corporate liquidations."

It should be noted that it is only the loss on the liquidation distribution itself (i.e., the stockholder's loss[73]) that is freed from the restrictions of Section 267. If the corporation, in the process of liquidation, sells assets to a related party at a loss, the restrictions apply.[74]

h. Avoidance of partnership status. In determining whether Section 267 applies when a corporation is a party to a sale or exchange, as already explained, a stockholder is considered as owning the stock of his "partner." Hence, it is important that individuals not fall unwittingly into partnership status.

In *Homes Beautiful, Inc.*,[75] the corporate stock was owned by X (50 per cent), Y (25 per cent), and Y's wife (25 per cent). The corporation sold property to X and Y, each assuming liability for one-half the purchase price, and the corporation claimed a loss on the transaction. X and Y thereafter developed the property and sold it at a profit. They claimed they were merely co-purchasers, but the Tax Court held that they had not overcome the Commissioner's finding that they were partners. The corporation's loss was disallowed *in toto*, because each of the purchasers was considered as owning the stock of the other, so that each owned more than 50 per cent.

To avoid partnership status for purposes of Section 267, it may be desirable that individuals execute documents setting out in detail their relationship to each other and to any jointly owned property.

i. Sale to certain corporations. Mention has already been made that if there are two or more stockholders, each owning 50% or less of the stock (including stock deemed constructively owned), sales may be made without fear of Section 267.[76] Furthermore, since the test of relationship is the ownership of over 50% in *value* of the outstanding stock, one having a voting majority may deal with his corporation without regard to Section 267, provided unrelated parties own enough of other classes of stock to reduce his stock ownership below 50% in value.

Until 1954, it was possible to avoid former Section 24(b) by making a sale to a non-stock corporation (e.g., a charitable foundation) controlled by the seller,[77] but that loophole has now been closed. Losses are now denied on sales to or exchanges with an organization exempt under Section 501 (which would include not only charitable and educational foundations but pension and profit sharing trusts, labor organizations, certain clubs, etc.), if the seller or (if the seller is an individual) a member of his family directly or indirectly controls such organization. "Control," for this purpose, includes any kind of control, whether or not legally enforceable, and however exercisable or exercised.[78]

j. Summary. To safeguard tax losses, the best procedure is to sell to strangers.

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[71] 1954 IRC § 346; 1939 IRC § 115(i).

[72] 1954 IRC § 302; 1939 IRC § 115(g).

[73] The distributing corporation's loss, if any, on a liquidation distribution is expressly denied in 1954 IRC § 336.

[74] *Matthews* v. *Squire*, 59 F. Supp. 827, 33 AFTR 1114 (D.C. Wash. W.D. 1945).

[75] (1947) par. 47,166, Prentice-Hall Memorandum T.C.

[76] See footnote 2.

[77] *Jacob M. Kaplan*, 21 T.C. 136 (1953), on appeal to 2d Cir.

[78] H. Rep. No. 1337, 83d Cong., 2d Sess., p. A65.

If the taxpayer insists on selling to relatives or to corporations in which he, a member of his family or his partner has an interest, a copy of Section 267 had better be kept at hand. The taxpayer may, without fear of Section 267, sell to relatives not deemed members of his family, friends, partners or other business associates, fellow-stockholders, fellow-beneficiaries of a trust or estate, corporations in which he owns (actually or constructively) 50 per cent or less in value of the stock, many other persons with whom he shares monetary or social interests, or to outsiders. One controlled corporation may sell to another, and a parent corporation may sell to a subsidiary, if in each instance neither corporation was a personal holding company for its taxable year preceding the sale. All such sales free of Section 267, however, are subject to the following cautionary note.

15. Status of Transactions to Which Section 267 Does Not Apply

If it is found that Section 267 is inapplicable to the particular transaction involving related taxpayers or entities, analysis cannot end there, for loss nevertheless may be disallowed,[79] as stated in Section 1 of this chapter. The circumstances in which this may happen, and the proper steps which may be taken to establish the loss deduction, are discussed in the remaining sections of this chapter.

16. Loss Disallowance under General Principles Implicit in the Internal Revenue Code

Prior to the enactment of Section 24(a)(6) of the Revenue Act of 1934 [the predecessor to Section 24(b) of the 1939 Code and Section 267 of the 1954 Code], losses from transactions between related taxpayers and entities were disallowed under general principles inherent in the income tax statute. These principles, and the decisions construing them, are still important in so far as they apply to transactions falling outside Section 267.

In applying these principles, the person claiming the loss deduction may be required to answer a number of basic questions, some of which overlap. The major ones are as follows:

1. Was the transaction bona fide? At arm's length? Was there a fair exchange of consideration?
2. Did the transferor retain any interest in the property?
3. Was there any understanding that the property would or might be transferred?
4. What is the history of the parties' relations with each other generally? Particularly, is their relationship such that one has the authority to control the other?

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[79] The legislative history of former § 24(b) makes this clear. See particularly, the following statement in the report of the House Ways and Means Committee on the Revenue Bill of 1937 (75th Congress, 1st Sess., H.R. Report No. 1546, p. 26, 1939-1 C.B. (Part 2) 704, 723): ". . . as in the case of the provisions of existing law, it is not intended by this amendment to imply any legislative sanction of claiming deductions for losses on sales or exchanges in cases not covered thereby, where the transaction lacks the elements of good faith or finality, generally characterizing sales and exchanges of property."

If so, is such authority exercised in practice, or do the parties usually act independently of each other? Did they do so in this instance?

5. Was there a business purpose for the particular transaction, or was it solely tax-motivated?

For convenience in dissecting these questions, the problems in the remaining portion of this chapter are considered under the following headings:

Section

Transactions between a parent and its subsidiary corporation . . . 17
Transactions between two corporations controlled by the same interests . . . 18
Transactions between a corporation and a stockholder owning less than a controlling interest . . . 19
Transactions between certain individuals . . . 20
Suggested steps to establish the loss deduction . . . 21

17. Transactions between a Parent and Its Subsidiary Corporation

Many of the problems under this heading have stemmed from the decision in *Higgins* v. *Smith*.[80] The Supreme Court held in this case that an individual was not entitled to deduct a loss from the sale of securities to his wholly-owned corporation, even though the sale occurred at a time prior to the effective date of former Section 24(b) or its predecessor section. Mr. Smith's corporation had been created and was operated to achieve tax advantages, particularly through securities transactions with the individual. The very sale in question had no business purpose, but was solely to reduce the individual's tax liability. His subordinates were the officers and directors of the corporation, and he directed its activities. It was held that the transaction did not satisfy Section 23(e) of the Revenue Act of 1932 (now Section 165), permitting deductions for losses "sustained during the taxable year." Standing by itself, the following language in the Court's opinion, however, appeared to go beyond the necessities of the case:

> . . . this domination and control is so obvious in a wholly owned corporation as to require a peremptory instruction that no loss in the statutory sense could occur upon a sale by a taxpayer to such an entity.

Applied literally, the quoted language would disallow every loss from a sale between a parent corporation and its wholly owned subsidiary, as well as between an individual and his wholly owned corporation. Fortunately, the courts have not permitted this language to be lifted from its context, but instead have considered each new case on its facts.

Thus the Supreme Court in *Moline Properties, Inc.* v. *Commissioner*[81] referred to the *Smith* case as follows:

> . . . In general, in matters relating to revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction. *Higgins* v. *Smith*; . . . *Gregory* v. *Helvering* . . .

Another court stated, in *Commissioner* v. *Laughton*,[82] that a transaction—

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[80] 308 U.S. 473, 23 AFTR 800 (1940).

[81] 319 U.S. 436, 439, 30 AFTR 1291 (1943).

[82] (9 Cir. 1940) 113 F. 2d 103, 104; 24 AFTR 340.

> . . . is not an unreal attempt to use a corporation for a sham transaction, procuring an advantageous tax consequence to the taxpayer, if it may be considered as one primarily for an independent business purpose and not a transfer of assets . . . with a retention of their control, solely to reduce tax liability.

On the other hand, a court found such a transfer of assets between stockholders and corporation "solely to reduce tax liability," in *Wickwire* v. *United States*.[83]

With the foregoing background, the Tax Court considered the case of *Crown Cork International Corporation*,[84] involving a sale at a loss by a parent corporation to its wholly owned subsidiary. Since neither corporation was a personal holding company for its preceding taxable year, former Section 24(b) was inapplicable. The court, after quoting from *Higgins* v. *Smith*, particularly in relation to *Gregory* v. *Helvering*, indicated that not all losses from sales between a corporation and its wholly owned subsidiary are to be disregarded, but that such losses are to be disallowed where either (1) the relation between the two corporations is such that they are in fact inseparable, or (2) the transaction itself has no purpose other than tax avoidance.[85] The court disallowed the loss in this case because it found both these factors present. Either would have been enough.

18. Transactions between Two Corporations Controlled by the Same Interests

As in the case of transactions between parent and subsidiary companies, sales or exchanges between two corporations controlled by the same interests are free of Section 267 if neither corporation was a personal holding company for its taxable year preceding the sale or exchange. Should Section 267 be inapplicable for the foregoing or any other reason, the transaction between the two corporations nevertheless will be closely examined to insure its good faith and economic reality.[86] Two illustrations probably will suffice.

In *Anderson, Clayton & Co., Transferee*,[87] corporation A owned all the stock of corporation B, as well as 89.5 per cent of the stock of corporation C. Originally, B and C had operated cotton oil mills, but in different areas. B's mill had burned, and it was found that it could not be rebuilt. B still had 23 cotton gins, but it lacked personnel and management to operate them, whereas C, which had been buying at prevailing market prices all the seed produced by these gins, had both the personnel and management necessary to operate them, and believed that it could do so at lower cost to itself and more efficiently than had B. Upon the proposal of C, it was accordingly arranged that B sell the cotton gins to C for approximately $298,000, which C borrowed from A. The said amount was the value of the gins as shown on B's books, and their fair market value was not in excess of this figure. It was discovered later, however, that the gins had a cost basis greater than their value as shown on B's books, but the Commissioner held that B's loss on the sale could not be allowed, his contentions being that the transaction lacked business purpose, merely transferred assets from one of A's units or departments to another, and was a sham. The Tax Court concluded that the affairs of the three corporations had been kept separate (despite close relationship through stock ownership and through the same directors and officers in some instances), that there was a real business purpose for the transaction, that the transaction was bona fide, and that B actually sustained a loss.

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[83] (6 Cir. 1941) 116 F. 2d 679, 26 AFTR 192.

[84] 4 T.C. 19 (1944), affirmed (3 Cir. 1945) 149 F. 2d 968, 33 AFTR 1480.

[85] To the same effect are two decisions involving loss upon partial or complete liquidation of a wholly-owned subsidiary: *National Investors Corp.* v. *Hoey* (2 Cir. 1944), 144 F. 2d 466, 32 AFTR 1219; and *Rhode Island Hospital Trust Co.*, 7 T.C. 211 (1946).

[86] A. *Arena & Co., Ltd.*, v. *United States*, 103 F. Supp. 505 (D.C. Calif., S.D. 1952).

[87] (1948) par. 48,162 Prentice-Hall Memorandum T.C.

A result similar to that in the *Anderson, Clayton & Co.* case was reached in *Brost Motors, Inc.*[88] The latter taxpayer was an auto sales corporation. Its sales under time payment plans were financed, for the period 1936-1939, by a finance corporation controlled by the same stockholders (husband and wife) and managed by the same officers. A sister held stock in the auto sales corporation, but not in the finance corporation. The two corporations occupied the same offices, but kept separate accounts, held separate directors' meetings, kept separate minute books, and banked at different establishments. During the years 1940 through 1943 and most of 1944, the finance corporation was inactive. In the latter part of 1944 prospects for the auto sales corporation were unfavorable because of war conditions. To remove its real estate from involvement in possible failure of the auto sales corporation, this corporation transferred the real estate to the finance corporation at fair market value as determined by two real estate appraisers, this figure being about $38,000 less than the adjusted cost to the auto sales corporation. The finance corporation paid for the property by borrowing $90,000 from one of the stockholders, being unable to borrow elsewhere. In asserting that the loss on the sale must be disallowed, the Commissioner contended that the transaction was not bona fide, but the Tax Court disagreed, stating that, if made for security reasons as in this case, a transfer has a business purpose and is not solely to reduce tax liability. The court also rejected the Commissioner's contention that the sale should be regarded as without substance because the corporations were controlled by the same interests.[89] Nor did the court regard the finance corporation as unreal or a sham so as to justify the court's ignoring its corporate entity. Finally, the court concluded that the property had been sold for its fair market value.

19. Transactions between a Corporation and a Stockholder Owning Less Than a Controlling Interest

Section 267 disallows loss from sales or exchanges between an individual and a corporation more than 50 per cent of whose stock is actually or constructively owned by such individual. There are, however, circumstances in which, under general principles of the income tax law, loss is disallowed on transactions between a corporation and an individual owning less than a controlling stock interest. This occurred in *Wickwire* v. *United States*,[90] where two otherwise unrelated individuals, each owning 47½ per cent of the stock of a manufacturing corporation, jointly transferred securities to it as part of an arrangement having no purpose other than the creation of tax losses.[91] It was held that the transfers were not in good faith.

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[88] (1948) par. 48,226 Prentice-Hall Memorandum T.C.

[89] The court cited at this point *General Securities Co.*, 38 B.T.A. 330 (1938); *Shelden Land Co.*, 42 B.T.A. 498 (1940); and *Wilhelmina Dauth*, 42 B.T.A. 1181 (1940).

[90] See footnote 83.

In *Helvering* v. *Johnson*,[92] on the other hand, the Supreme Court by an evenly divided vote affirmed a circuit court decision[93] allowing a loss from a pre-Section 267 transaction in which a stockholder sold property to a corporation organized solely for tax purposes, its stock being owned 49.9 per cent by him, 49.9 per cent by his wife, and 0.2 per cent by a nominee. The provisions of Section 267, of course, would disallow such loss today. Would the loss now be allowed if the selling stockholder and the other stockholder were neither partners nor members of the same family, as defined in Section 267? It is possible that the courts would extend to this situation, involving a corporation with no business purpose, the decision in *Higgins* v. *Smith*,[94] which was decided shortly after *Helvering* v. *Johnson*, and would therefore disallow the loss.

20. Transactions between Certain Individuals

Partners or other business associates, close friends, relatives not deemed "members of a family," [95] stockholders of the same corporation, beneficiaries of the same trust or estate, and many other individuals having pecuniary or social interests in common, may sell property to each other, or exchange property, without fear that the loss will be disallowed by Section 267. Under general principles implicit in the income tax statute, however, a transaction between these individuals is subject to special scrutiny to insure its good faith. If the transaction does not meet this test, the loss will be disallowed.

Good faith, or the lack thereof, will be determined upon a study of all the circumstances, including the nature of the special relationship between the parties. Is this relationship such that one would be unlikely to act independently of, and adversely to, the other? Was the transaction consummated at arm's length, that is, did the parties act in a businesslike manner, as would two unrelated persons? [96] Was the price a fair one? Did the transferee pay at once, or was the transaction on credit? If on credit, when did the transferee liquidate his obligation, and from what source? If he paid at once, did he use funds loaned or given by the transferor? If he used loaned funds, has the loan been repaid? If the latter, was the gift conditioned upon the money being used to "purchase" the property? Did title actually pass, and did the dominion and control of the transferor cease? Did his interest terminate in an economic as well as a legal sense? Was the transaction final, or was there an understanding, tacit or otherwise, that the property would be reconveyed? Was it ever reconveyed? If so, for what price, and for what reason? The answers to these questions largely will determine the good faith of the transaction.

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[91] The *Wickwire* case involved a year (1929) to which the provisions of neither § 267 nor its predecessor sections applied. If the same facts were presented today, § 267 might apply, inasmuch as the two stockholders, although otherwise unrelated, were operating a joint trading account, and hence might be deemed "partners," so that each would be considered as owning a 95 per cent stock interest in the corporate party to the transaction. See *Homes Beautiful, Inc.*, footnote 75.

[92] 308 U.S. 523, 23 AFTR 788 (1939).

[93] (8 Cir. 1939) 104 F. 2d 140, 23 AFTR 20.

[94] See footnote 80.

[95] See the definition in 1954 IRC § 267(c)(4); 1939 IRC § 24(b)(2)(D).

[96] See *Wilhelmina Dauth*, footnote 89, at 1189.

21. Suggested Steps to Establish the Loss Deduction

The facts must be shown to be such as to establish:

1. That the parties are separate from, and independent of, each other to a degree that justifies the recognition of one as seller and the other as buyer;
2. That the particular transaction is in good faith; and
3. Where the parties are two related corporations, or a corporation and individual stockholder, that the transaction has a business purpose and is not motivated solely by tax considerations.

In establishing (1), (2), and (3), the proof tends largely to overlap, and therefore no particular effort henceforth will be made to maintain any segregation in respect of these three elements.

One should study the tax and business background of the parties to the transaction, ascertaining particularly whether they have in the past had similar dealings with each other or with any related individuals and corporations. If they have, and these were not at arm's length, the immediate problem is made more complicated, for in these circumstances the tax authorities may begin with the assumption that the present transaction is part of a pattern of irregularities.

The related parties should in all instances anticipate that they will be asked to supply evidence as to the reality of the transaction, and should govern themselves accordingly. In the case of a sale or exchange between parent and subsidiary, or between two controlled corporations, for example, evidence of separate identity should be readily available, including charter provisions, the history as to the creation (particularly the purposes) and operations of the two corporations, books, records, corporate minutes, bank accounts, information relating to physical plant, methods of financing, etc. If possible, the particular transaction should be consummated without borrowings within the group, although this is not essential. It should be made clear, in so far as feasible, that the officers and directors of each corporation considered the transaction upon its merits.[97] This is easier of accomplishment, of course, if the two corporations maintain separate organizations, and have entirely different officers and directors. Even with much overlapping in the corporate organizations and directorates, however, it still may be shown that in practice the two corporations could reach decisions independently of each other and independently of their stockholders, and accordingly that there was not such dominance and control as to make the transaction unreal.[98] The dominance and control of one party by the other (or dominance and control by common interests) appear to lose much of their significance in the view of the courts, if the following conditions exist: the original organization and separation of the two corporations were for a business purpose, the transaction in question was also for a business purpose, and was consummated upon terms fair to both parties. There is in these circumstances a disposition to view the corporations as separate entities and to conclude that the transaction is marked by the requisite finality. This is also true of transactions between a corporation and an individual stockholder.[99]

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[97] A Federal Court has listed the following as criteria in determining the reality of the dealings between parent and subsidiary: ". . . autonomy of the subsidiary, the purpose of its creation, the extent of its freedom of action, whether the transactions in question were at arm's length, the method of doing business, the usual nature of the parent's and subsidiaries' operation, the honesty or dishonesty involved in the transactions, the reality or the unreality of the business judgment which dictated them." *Standard Oil Co.* v. *United States,* 63 F. Supp. 48-59, 34 AFTR 682 (D.C. N.D. Ohio 1945).

[98] As stated by the Tax Court in *Rhode Island Hospital Trust Co.,* footnote 85: "There is, of course, always a certain measure of control exercised by a parent corporation over its sub-

Conversely, even when there is independent management of the corporation or corporations, a loss from a transfer within the related group is not recognized as real and final if the transfer lacks a business purpose. Hence, in this type of transaction one cannot overestimate the importance of having a clearly defined and unassailable business purpose, as distinguished from a tax purpose.

If, on the other hand, continuing beneficial ownership of property is not involved, as where one sells at a fair price to a complete stranger, the purpose of the transaction is totally irrelevant, even though the seller's sole purpose be the taking of a tax deduction.

Good faith, which must always be present, is further evidenced by fair terms and a fair price, viewed from either side of the transaction. When the market value of the property at the time of the proposed transaction is not definitely known and publicly accepted, it is generally wise to have an evaluation made by independent appraisers whose opinion will be respected by the courts. Finally, there should be nothing in the terms of transfer, or in the surrounding circumstances, indicating that the transferor intends to recapture the property with the co-operation of an amenable transferee.

22. Summary

Losses from bona fide sales or exchanges between controlled companies and other related taxpayers will be allowed, provided that Section 267 is inapplicable to the particular transfer. In some instances, the test of good faith requires the presence of a business purpose. One should, however, act in all cases upon the assumption that the transaction will be subjected to the closest scrutiny.

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sidiary," . . . the court indicating further that the question in the particular case was whether there was present "that kind of domination and control which would warrant a disregard of the separate corporate existence." The court found it was not present in this case.

[99] In this instance, however, § 267 has a longer arm, since it disallows the loss where the individual stockholder owns more than 50 per cent in value of the outstanding stock, regardless of whether the corporation was a personal holding company for its last taxable year.

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How to Handle Transactions by Controlled Business Groups

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1. Points to Consider

Whenever your client controls more than one business, there is the danger that the Commissioner may attempt to allocate income or deductions between the businesses under Section 482, 1954 IRC (1939 IRC § 45). You are then concerned with these considerations:

Section
When the law applies 2
When you can divide a business without allocation 3
How to make intercompany sales 4
Income cannot be created nor deductions disallowed 5
What happens after allocation by the Commissioner 6
Use of Section 482 by taxpayer 7

2. When the Law Applies

Transactions by and between controlled persons in any trade or business get special scrutiny.[1] (A controlled person is any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.) This is to find whether the control is being used to reduce, avoid, or escape taxes.[2] The law gives the Commissioner the authority to determine *true* net income. The standard to be used by the Commissioner is that of uncontrolled persons dealing at arm's length with one another.[3]

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[1] See Revenue Ruling 15, 1953-1 C.B. 141, where corporations organizing Western Hemisphere trade corporations are cautioned to conduct transactions between them on "arm's length" basis since § 45 (1954 IRC § 482) may be applied in such cases where necessary to prevent evasion of taxes or clearly to reflect the income of either of the separate companies.

[2] IRC § 482. The statute speaks of "evasion" of taxes, a word which the courts construe to mean "avoidance." Therefore, while the avoidance is legal, it still permits allocation under this section. *Asiatic Petroleum* v. *Commissioner* (2 Cir. 1935), 79 F. 2d 234, 16 AFTR 610, cert. den. 296 U.S. 645; *Central Cuba Sugar Co.* v. *Comm.* (2 Cir. 1952), 198 F. 2d 214, 42 AFTR 347, cert. den. 344 U.S. 874.

[3] Reg. 118, § 39.45-1(b).

The regulations[4] define the terms used in the law.

Trade or business is any trade or business activity of any kind. It is immaterial whether the business is owned individually or otherwise. Nor does the place of organization or the place where the business is carried on make any difference.

Controlled means any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised. It is the *reality* of the control which is decisive. It is not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

The Commissioner may argue that principal stockholders so dominate a company that it should not be recognized as a separate corporate entity for tax purposes. One case involved sales between an individual and his wholly-owned corporation—a corporation which "was his corporate self." The decision established the proposition that the Commissioner is not bound to acquiesce in his decision as to how he does business. He may look at actualities. Upon determining that the form used for doing business "is unreal or a sham he may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute."[5] That decision, however, does not give the Commissioner a free rein to recognize or not to recognize corporate entities at will. Disregard of a corporate entity under Supreme Court cases is dependent upon finding that it is a fiction or a sham. There is no disregard if the corporation serves some industrial, commercial or other activity besides the avoidance of taxation.[6]

The passive ownership of corporate shares falls short of qualifying as a business.[7] But a holding company, having the care of investments and, through voting rights, the control of various subsidiaries, may be engaged in the conduct of a business. It may incur deductible expenses in connection with that. It may make expenditures designed to safeguard its holdings and protect its investments. But a clear distinction is drawn between activities as a shareholding investor—and the business of the corporation which the investor owns.

If one company owns another or there is a common ownership, the Commissioner may reallocate income or deductions where it is essential "to prevent evasion or clearly to reflect income." But that does *not* apply when both companies jointly own a third. Apportionment, said one court, is not possible if each of the parents holds half of the stock of the company used as an alleged source of manipulation.[8]

Although a *controlled person* has been previously defined as any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, it cannot be presumed that husbands control their wives' shares in the business.[9]

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[4] Reg. 118, § 39.45-1(a).

[5] *Higgins* v. *Smith*, 308 U.S. 473, 23 AFTR 800 (1939).

[6] *J. E. Dilworth Co.* v. *Henslee* (D.C., Tenn. 1951) 98 F. Supp. 957, 40 AFTR 1160; *Allan Bond*, 14 T.C. 478 (1950); *Coneland Water Co.* v. *U.S.* (D.C., N.D. Cal. 1954) 72625 P-H Fed. 1954.

[7] It has been indicated that control of the business does not necessarily mean control of the stock. *Central Auto Equipment Co.*, 7 B.T.A. 1068 (1927). This section does not require stock control, only control of the business. Reg. 118, § 39.45-1(a)(3).

[8] *Lake Erie and Pittsburgh Railway Co.*, 5 T.C. 558 (1945).

[9] *A. G. Nelson Paper Co., Inc.* (1944), par. 44,286 Prentice-Hall Memorandum T.C.; *Epsen Lithographers, Inc.* v. *O'Malley*, 67 F. Supp. 181 35 AFTR 208 (D.C. Neb. 1946). See

It is immaterial that a particular company is part of an affiliated group which files a consolidated return. Section 482 can be applied to determine the individual company's net income before it is consolidated. Consolidation would ordinarily bring about results similar to those obtained by the application of Section 482. In some situations the separate company's net income is necessary in computing consolidated return adjustments.[10] Then the application of Section 482 to that company can become important. However the Commissioner cannot apply Section 482 to bring about the same result in the case of separate returns as would occur if consolidated returns were filed.[11] Where it is determined that all income in fact is earned by one company then there is no income to be reported on separate returns and it is thus immaterial that the result achieved amounts to a consolidation of the income of the various companies.[12]

True net income is the net income (or any item or element affecting it) which would have resulted to the controlled person, had the controlled person in the conduct of its affairs (or in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the controlled group *at arm's length.* It does not mean the income, the deductions, or the item or element of either, resulting to the controlled person by reason of the particular contract or arrangement, which the controlled person, or the interests controlling it, chose to make (even though the contract or arrangement be legally binding upon the parties).

Allocation of income and deductions is permitted where there are:

Incorrect accounting methods
Questionable and sham transactions
Methods used to distort or shift income and deductions to avoid tax
Transactions involving fraud
Incomes of the controlled persons which would have been different if the transactions had been at arm's length. It does not matter whether this results from deliberate or inadvertent conduct.

3. When You Can Divide a Business without Allocation

In order to split income, businesses are often divided. Part of the corporation's business is transferred to the stockholders operating as a partnership or single proprietorship or to a subsidiary corporation.[13] The Commissioner has attempted

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Gordon Can Co., 29 B.T.A. 272 (1933); *John L. Denning & Co.* v. *Comm.* (10 Cir. 1950) 180 F. 2d 288, 38 AFTR 1508.

[10] For example, the limitations on net loss carry-overs from separate returns, capital loss limitations, etc.

[11] *Lesoine* v. *U.S.* (D.C. Calif., 1943), 32 AFTR 1686.

[12] *Advance Machinery Exchange, Inc.* par. 49,026 Prentice-Hall Memorandum T.C. (1949), aff'd (2 Cir. 1952) 196 F. 2d 1006, cert. den. 344 U.S. 835 (1952). The Tax Court found that in reality there was only one taxable entity and all of the income of the business was attributable to it under the broad scope of § 22(a), 1939 IRC (1954 IRC § 61(a)). In affirming the decision, the Court of Appeals relied on § 45 1939 IRC (1954 IRC § 482) rather than § 22(a).

[13] When a subsidiary is formed, dangers other than the possible application of Section 482 must be considered. There will be an additional tax on the intercorporate dividends. Salaries paid to principal stockholders may have to be cut. If the stockholder is now engaged in both businesses, the reasonable worth of his services to the original corporation may now be diminished. (See *Miles-Conley Co., Inc.*, 10 T.C. 754 (1948).) Under certain circumstances the

to use Section 45 (1939 IRC) to allocate back to the original business the income of the new enterprises. However, where the division is bona fide, he has been unsuccessful.

Court decisions permit the organizing of a corporation, partnership or sole proprietorship to do some of the business done before by the controlling person.[14] If there is a natural division between the business functions of the corporation and the partnership, each is taxed separately. Some permissible divisions are cases where:

> One business manufactures, the other sells and distributes and/or furnishes miscellaneous services[15]
> One business operates the property, the other owns it [16]
> One business trades for its own accord, the other acts as a broker[17]
> One business performs certain manufacturing operations, the other performs different manufacturing operations[18]
> One business sells certain products, the other sells different products.[19]

Another case[20] said that in the split-off from the corporation it makes no difference that the corporation could have done all the things the new business is doing; the split-off may not have been in the best corporate interest. But, it is not permissible to organize a separate business that is a shell or sham merely to shift profits.[21] In another case,[22] the stockholders of a corporation in the printing business formed a partnership. The corporation agreed to turn over to the partnership all receipts from sales after taking a 10 per cent profit. The court said the entire income belonged to the corporation. The partnership did not do anything to produce the income.[23]

Just as the Commissioner is unable to combine the results of separate business groups, the taxpayer is similarly restricted. For example, you cannot set up separate management-subsidiary-corporations and treat their income as yours. The

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transferee corporation may lose its $25,000 surtax exemption (1954 IRC § 1551; 1939 IRC § 15(c)). Finally, the transfer of property to the new corporation (where a tax-free transfer is not possible) may result in a tax to the original corporation.

[14] *Seminole Flavor Co.*, 4 T.C. 1215 (1945); *Buffalo Meter Co.*, 10 T.C. 83 (1948).

[15] *Seminole Flavor Co.*, 4 T. C. 1215 (1945); *Barq's Bottling Co.* (1946), par. 46,150 Prentice-Hall Memorandum T.C.; *Cedar Valley Distillery, Inc.*, 16 T.C. 433 (1951); *Chelsa Products Inc.*, 16 T.C. 840 affirmed (3 Cir. 1952) 197 F. 2d 620, 42 AFTR 212; *Est of Julius I Byrne*, 16 T. C. 1234 (1951); *Seminole Rock & Sand Co.*, 19 T.C. 259 (1952).

[16] *Ames Theatre Co.* (1946), par. 46,016 Prentice-Hall Memorandum T.C.; *Fair Price Stations, Inc.* (1946) par. 16,120 Prentice-Hall Memorandum T.C.; *Twin Oaks Co.*, par. 49,067 Prentice-Hall Memorandum T.C. (1949) reversed (9 Cir. 1950) 183 F. 2d 385, 39 AFTR 753; *Palm Beach Aero Corp.*, 17 T.C. 1169 (1952); *Matherne et al* v. *Scofield* (D.C. Texas 1952); *Coca-Cola Bottling Co. of Sacramento*, 17 T.C. 101 (1951).

[17] W. R. Ross, 43 B.T.A. 1155, reversed (5 Cir. 1942), 129 F. 2d 310, 29 AFTR 829, remanded (1943), par. 43,423 Prentice-Hall Memorandum T.C.

[18] *Buffalo Meter Co.*, 10 T.C. 83 (1948).

[19] *Rolland Motor Co., Inc.*, par. 53,049 Prentice-Hall Memorandum T.C. (1953).

[20] *Buffalo Meter Co.*, footnote 18, above.

[21] *Forcum-James Co.*, 7 T.C. 1195 (1946), remanded pursuant to stipulation (6 Cir. 1949); *Kocin, Trustee* v. *U.S.* (2 Cir. 1951), 187 F. 2d 707, 40 AFTR 318. But see *The Friedlander Corp.*, 19 T.C. 1197 (1953), reversed (5 Cir. 1954) 216 F. 2d 757.

[22] *R.O.H. Hill, Inc.*, 9 T.C. 153 (1947).

[23] See also *Oppenheim's Inc.* v. *Kavanaugh* (D.C., Mich. 1950) 90 F. Supp. 107, 39 AFTR 468.

court has held that each corporation is separate and must be treated that way.[24]

In one case,[25] two ice companies (controlled by the same interests) agreed that one would shut down except during the busy season. This was intended to produce more efficient operation. The corporation that remained in operation the entire year attempted to shift some of its income to the other corporation. It claimed that by having the other shut down for part of the year, the two were engaged in a joint venture and the income should be divided. The court refused to let them combine the operations of the two companies.

If when paid by the subsidiaries, the expense is of a character to be an expense deductible by them, it is not available to the parent company. The subsidiaries are entities distinct from the parent—although their economic advantages redound to the parent company's benefit. The Supreme Court has meticulously distinguished between the two.[26]

4. How to Make Intercompany Sales

Sales and transfers between affiliated companies may cause the Commissioner to attempt an allocation of income or deductions under Section 482. You cannot buy from an affiliate at a price far above or below market and then sell at a loss or a gain. At the time you sell, the gain or loss attributable to the difference between your purchase price and the then market price may be allocated to the affiliate.[27]

In one case securities were sold to a foreign affiliate at cost. This was far below market. The affiliate sold at a gain outside the U.S. The affiliate could not be taxed, but the gain on the sale was allocated to the domestic company.[28]

If the property was acquired from an affiliate in a tax-free exchange, allocation is still possible.[29] In one case[30] a parent-company transferred to its wholly owned subsidiary some shares of stock. This was done tax-free under the provisions of Section 112(b)(5), 1939 IRC (1954 IRC § 351). Under Section 113(a)(8), 1939 IRC (1954 IRC § 362(a)), the subsidiary claimed as a basis for the stock the basis in the hands of the parent-company before the transfer. When the subsidiary sold the stock at a price below the basis, it claimed a loss for the difference. The loss was allocated back to the parent under Section 45 (1939 IRC).

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[24] *National Carbide Corp. et al.* v. *Commissioner,* 336 U.S. 422, 37 AFTR 834 (1949); *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590, 30 AFTR 1310 (1943).

[25] *Birmingham Ice & Cold Storage Co.* v. *Davis* (5 Cir. 1940), 112 F. 2d 453, 25 AFTR 86.

[26] *National Carbide Corp. et al.* v. *Commissioner,* 336 U.S. 422, 37 AFTR 834 (1949); *Interstate Transit Lines* v. *Commissioner;* 319 U.S. 590, 30 AFTR 1310 (1943); *Maine Central Transportation Co.,* 42 B.T.A. 350 (1940), remanded pursuant to stipulation (1 Cir. 1943).

[27] G.U.R. Co., 41 B.T.A. 223 (1940), affirmed (7 Cir. 1941), 117 F. 2d 187, 26 AFTR 386; *Pennsylvania Indemnity Co.,* 30 B.T.A. 413 (1934), affirmed (3 Cir. 1935), 77 F. 2d 92, 15 AFTR 1345, cert. den. 296 U.S. 588; *Majestic Securities Corporation,* 42 B.T.A. 698 (1940), affirmed (8 Cir. 1941) 120 F. 2d 12, 27 AFTR 358. In the latter two cases the same result was achieved, although the Commissioner did not rely on Section 45 (1939 IRC). Cf. *Shunk L. E. Latex Products, Inc.,* 18 T.C. 940 (1952), where allocation would have been proper if it had not been for OPA regulations.

[28] *Asiatic Petroleum Co.* v. *Commissioner* (2 Cir. 1935), 79 F. 2d 234, 16 AFTR 610.

[29] *Central Cuba Sugar Co.* 16 T.C. 822 (1951) reversed on this point (2 Cir. 1952) 198 F. 2d 214, 42 AFTR 347 cert. den. 344 U.S. 874. Certain expenses incurred by transferor corporation, prior to reorganization, in connection with income that was earned after transfer of assets were allocated to transferee corporation in order to clearly reflect income.

[30] *National Securities Corporation,* 46 B.T.A. 562 (1942), affirmed (3 Cir. 1943) 137 2d 600, 31 AFTR 456, cert. den. 320 U.S. 794.

In the *National Securities* case, the court upheld the application of Section 45 on the grounds that the allocation was required to clearly reflect the parent-company's income. It is believed, however, that the section should not apply to transactions governed by Subchapter C, 1954 IRC (1939 IRC §§ 112 and 113) where there was a legitimate business purpose and no attempt at tax avoidance. In this connection, it is also suggested that it is better to dissolve the transferor corporation than to merely maintain it as a shell corporation after the transaction. Then if the Commissioner attempts an allocation when the transferred property is finally sold, there will be no other company to which to allocate any gain or loss. This is equally true in the case where property is bought or sold rather than transferred tax-free.[31]

The price charged the affiliate is the important question when there is an attempt by the Commissioner to allocate income or deductions after the affiliate disposes of the property. Before setting a price on intercompany sale, consider the following:

1. The price or fee you charge must bear some ratio to the price you charge others. It should at least cover cost of production, including a part of overhead.[32]
2. Do not vary the price in proportion to your profits. That prevents charge of diverting profits. Keep the charge constant.
3. Set up parts of the enterprise as separate entities in fact. Have each unit pay its own expenses. Charge each company with a proper proportion of joint expenses such as administrative overhead. This ratio should be consistent and logical. Do not vary the charge with changing profits.
4. You can make *special terms* for affiliates, if you have good reasons, such as: Lower prices and resultant lower profits because both are members of the same group. There is no credit risk. There will be no unreasonable return of merchandise. A new affiliate can be treated as a favored customer. You would sell to an outsider at the same price and terms if you knew the outsider as well as you know the affiliate.
5. Avoid year-end manipulation of prices. Have the agreement specific and definite.

Courts say there is an arm's length transaction (not a method of shifting profits for the purpose of evading tax) if separate books and records are kept which clearly reflect the income of the several units of a business.[33] The heart of the difficulty in many cases seems to be inaccurate accounting. The records should precisely determine all income and expenses so that net income can be readily determined.

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[31] See Cooper, "Section 45," *Tax Law Review*, 1949, Vol. 4, pages 131, 155-159. In two cases Commissioner was unsuccessful in his attempt to allocate income to transferor corporation where it was maintained as a shell after the transaction: *Burrell Groves Inc.*, 16 T.C. 1163 (1951); *Lake Yale Groves, Inc.*, par. 51,178 Prentice-Hall Memorandum T.C. (1951).

[32] See *The Friedlander Corp.* 19 T.C. 1197 (1953).

[33] *Drawoh, Inc.*, 28 B.T.A. 666 (1933), Commissioner's appeal dismissed by consent (7 Cir. 1935), 74 F. 2d 1011, 15 AFTR 121; *Seminole Flavor Co.*, 4 T.C. 1215 (1944).

Other indications of arm's length transactions are:[34]

1. There is no doubt as to the legal organization and existence of the separate units as going concerns.
2. The contract between the units is reasonable. The heart of the contract is the compensation, rentals, or other payments agreed upon by the parties. They must be fairly arrived at. This section seeks only to adjust and correct improper bookkeeping entries between separate businesses. It may not be used to justify arbitrary consolidation of the net income of separate companies.
3. Payments between the companies are comparable to those paid elsewhere for similar services.
4. Taxes are not reduced or avoided by unfairly shifting or distorting income or deductions of either business. That means that sham transactions, fictitious sales on an artificial basis, should be avoided.

5. Income Cannot Be Created nor Deductions Disallowed

Section 482 permits the Commissioner to allocate income and deductions. But it does not allow him to create income or disallow true deductions. You can transfer the use of your property to a controlled person without a charge to it. The courts have refused to allow the Commissioner to assign to you what would have been rent income if you rented the property.[35] It is possible that the Commissioner could allocate to you some of the income from the controlled person to whom you transferred the property.

In one case[36] a corporation owned the working interests in leases subject to oil payments. The rights to the oil payments were owned by another corporation controlled by those who controlled the first company. The second company transferred its rights to the first company without receiving anything for them. The first company consequently did not have to pay the oil payments. The Commissioner was not allowed to create income to the first company as a result of the cancellation of the oil payments.

In another case[37] a subsidiary company loaned money to its parent without interest. The Commissioner's action in adding to subsidiary's income an amount representing interest was held to result in the creation of income which was not warranted under Section 45 (1939 IRC).

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[34] *Fair Price Station, Inc.* (1946), par. 46,120 Prentice-Hall Memorandum T.C.; *Barq's Bottling Co.* (1946) par. 46,150 Prentice-Hall Memorandum T.C.; *Epsen Lithographers, Inc.* v. *O'Malley* (D.C. Nebr. 1946) 67 F. Supp. 181, 35 AFTR 208; *Buffalo Meter Co.*, 10 T.C. 83 (1948); *Briggs-Killan Co.*, 40 B.T.A. 895 (1939; *Wachtel Corp.* (1945), par. 45,250 Prentice-Hall Memorandum T.C.; *Nelson Paper, Inc.* (1944), par. 44,286 Prentice-Hall Memorandum T.C.; *Miles-Conley Co., Inc.*, 10 T.C. 754 (1948); *Koppers Co.*, 2 T.C. 152 (1943); *Motors Securities Company, Inc.*, par. 52,316 Prentice-Hall Memorandum T.C. (1952); *Grenada Industries, Inc.* 17 T.C. 231 (1951), affirmed (5 Cir. 1953) 202 F. 2d 873, 43 AFTR 450, cert. den. 346 U.S. 819 (1953). *Coca-Cola Bottling Co. of Sacramento Ltd.*, 17 T.C. 101 (1951).

[35] *Tennessee-Arkansas Gravel Co.* v. *Commissioner* (6 Cir. 1940), 112 F. 2d 508, 25 AFTR 97.

[36] E. C. *Laster*, 43 B.T.A. 159 (1940), modified on other points (5 Cir. 1942) 128 F. 2d 4, 29 AFTR 465.

[37] *Smith-Bridgman & Co.*, 16 T.C. 287 (1951). Also in *Texsun Supply Corp.*, 17 T.C. 433 (1951) it was held that § 45 (1939 IRC) did not permit the allocation of income where in fact none existed.

As to deductions, you may take a loss on a sale to a controlled corporation.[38] This section does not permit the Commissioner to disallow a deduction,[39] only allocate it. Of course, the deduction may be disallowed for other reasons.[40]

Although deductions cannot be disallowed, they can, of course, be allocated. The Commissioner can allocate expenses between controlled businesses, even if—

1. The two businesses did not result from the splitting of an existing business
2. The company to which a loss or expense is allocated cannot get any tax benefit from it[41]
3. The company to which the loss or expense is allocated is tax exempt[42]
4. The expense was not paid by the company to which it is allocated.[43] If the expense was paid by one company for its own benefit and the benefit of another, there may be a proration. The amount prorated to the other company is not then deductible by the company that made the actual payment.[44]

6. What Happens after Allocation by Commissioner

What happens after the Commissioner is successful in allocating income or deductions? Suppose that a deduction is disallowed to one company for charges paid to an affiliated company. If the latter company now refunds the disallowed deduction, is that income to the company receiving the refund? It would seem that the tax benefit rule should prevail and that there should be no income.[45] The company receiving the refund gets no benefit from the deduction because of the Commissioner's action in applying Section 482.

Where income has been allocated, can the company to which it was allocated now actually receive that income from the other controlled person without paying a tax? There are no cases on this point. But it would seem that the recovery should be possible without further tax.[46] The Commissioner's allocation assumes that this income has always belonged to the company to which it is assigned.

But there may be tax difficulties where the actual recipient of the income keeps it after it has been allocated to a controlled company. Where you are a stockholder in the company to which the Commissioner has been successful in allocating to the corporation the income received directly by you, the courts say that even though the corporation has been taxed, you have received a constructive dividend. You have to pay a tax too.[47] You and your family may control more than one corporation. One corporation may pay you a dividend. If those earnings are allocated to one of the other corporations, you will be taxed as if you received the dividend from the second corporation, not the first.[48] Your stockholding percentages in each corporation may be different. The allocation may increase your tax.

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[38] *General Industries Corp.*, 35 B.T.A. 615 (1937).

[39] *Hypotheek Land Company*, 16 T.C. 1268 (1951), reversed (9 Cir. 1952) 200 F. 2d 390, 42 AFTR 963.

[40] For example it may be disallowed under 1954 IRC §§ 261-273; 1939 IRC § 24 or 129. See the following chapters elsewhere in this book: Mintz, "How to Handle Sales Between Controlled Companies"; Shelton, "What to Do About Section 269."

[41] *National Securities Corporation*, 46 B.T.A. 562 (1942), affirmed (3 Cir. 1943), 137 F. 2d 600, 31 AFTR 456.

[42] *Southern College of Optometry, Inc.* (1947), par. 47,079 Prentice-Hall Memorandum T.C.

[43] *Joseph J. Harris, Inc.* (1946), par. 46,129 Prentice-Hall Memorandum T.C.; *Central Cuba Sugar Co.* (2 Cir. 1952), 198 F. 2d 214, 42 AFTR 347, cert. den. 344 U.S. 874.

[44] *Glenmore Distilleries Co.*, 47 B.T.A. 213 (1942). See *Essex Broadcasters, Inc.*, 2 T.C. 523 (1943).

[45] Reg. 118, § 39.22(b)(12)-1. For a complete discussion of this point see Cooper, "Section 45," *Tax Law Review*, 1949, Vol. 4, pages 131, 159-160.

[46] *Ibid.*; see footnote 36.

7. Use of Section 482 by Taxpayer

It is not possible to apply the allocation under Section 482 to yourself. Only the Commissioner may do the allocating under the section. The Regulations[49] maintain that you cannot employ the section nor compel the Commissioner to employ it. However, a dissenting opinion in the Board of Tax Appeals[50] (later adopted by the Third Circuit[51]) indicated that Section 45 (1939 IRC) might be applied for the taxpayer's benefit. In another case,[52] however, it was indicated that the Commissioner would not be overruled unless his position is arbitrary or an abuse of his discretion. This leads some to believe that they can ask the Commissioner to invoke Section 45 (now Section 482) and, if he refuses, can appeal to the courts, if they can indicate that his refusal is arbitrary and shows lack of discretion.[53]

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[47] *Forcum-James Co.*, 7 T.C. 1195 (1946), remanded pursuant to stipulation, 6 Cir., 8-15-49; *Hugh Smith, Inc.*, 8 T.C. 660 (1947).

[48] *Alfred W. Gordon*, 29 B.T.A. 275 (1933), reversed (8 Cir. 1937) 87 F. 2d 663.

[49] Reg. 118, § 39.45-1(b).

[50] *Autocar Co.*, 31 B.T.A. 361 (1935).

[51] (3 Cir. 1936) 84 F. 2d 772.

[52] *First Securities Corporation of Memphis* v. *Clements* (D.C. Tenn. 1937), affirmed (6 Cir. 1939) 103 F. 2d 1011.

[53] See Walter A. Cooper, "Section 45," *Tax Law Review*, 1949, Vol. 4, pages 131, 165.

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Rental and Royalty Arrangements Among Controlled Taxpayers

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Rental and royalty arrangements are appealing and often a successful technique for spreading income among controlled taxpayers.[1] However, any such transaction, intended to siphon off business earnings to lower bracket family members or related business interests, with a consequent reduction in tax impact, will be greeted by close scrutiny from the Internal Revenue Service.[2]

1. Points to Consider

Three sections of the now demised 1939 IRC were employed to attack rental and royalty arrangements among controlled taxpayers. These sections under the 1954 IRC have new numbers, but no substantive changes have been made:

1939 IRC Section	*1954 IRC Section*	*Section*
45	482	2
23(a)(1)(A)	162(a)	3
22(a)	61(a)	4

With no change in the law, existing rulings, regulations and decisions remain in status quo and continue to control. Recognizing, therefore, the continued risk of attack under one or more of the foregoing sections of the 1954 Code, how may controlled taxpayers successfully enter into rental and royalty arrangements?

	Section
Guide Posts for establishing deductibility	5

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[1] A controlled taxpayer is any one of two or more organizations, trades, or businesses, owned or controlled, directly or indirectly, by the same interests, Reg. 118, Sec. 39.45.

[2] *Stanwick's Inc.*, 15 T.C. 556 (1950), affirmed per curiam (4 Cir. 1951), 190 F. 2d 84, 40 AFTR 842; *Ingle Coal Corp.* v. *Commissioner* (7 Cir. 1949) 174 F. 2d 569, 37 AFTR 1485; *Roland P. Place*, 17 T.C. 199 (1951), Acq. 2 C.B. 3 (1952), affirmed *per curiam* (6 Cir. 1952) 199 F. 2d 373, 42 AFTR 701, cert. den. 344 U.S. 927 (1953).

2. Section 482 (formerly Section 45): Allocation of Income and Deductions Among Taxpayers[3]

This section has been construed by most courts:

1. to *permit* the Commissioner to apportion, among controlled taxpayers, true income realized or true deductions incurred by them in transactions with outsiders, and
2. to *deny* the Commissioner the right to create income or to disallow deductions, within a controlled group of taxpayers, where no true income has been realized or no true deductions have been incurred in transactions with outsiders.

Section 482 is not available to create income or to disallow deductions within the controlled taxpayer group itself.[4] Therefore, the general rule is that where no true income, or no true deduction items have been realized or incurred in transactions with outsiders, this provision of the tax law may not be used to re-align a purely intra-group arrangement.[5]

Where one member of a controlled group permits free use of its property to another member, Section 482 may not be used to create income to the member owning the property.[6] However, the property owner permitting free use by a related entity may be denied the depreciation deduction since, as to it, the property is no longer being used in its trade or business. Further, where the parties never intended any rental, the property is not held for the production of income within the meaning of Section 167(a)(2) of the new Code (formerly 1939 IRC Section 23(e)(2)).[7] The free user of the property, of course, has no basis for depreciation.

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[3] No substantive changes have been made. The only technical change was to substitute verbs, inserting "may distribute" in lieu of "is authorized to distribute."

[4] *General Industries Corp.*, 35 B.T.A. 615 (1937); *Tennessee-Arkansas Gravel Co.* (6 Cir. 1940) 112 F. 2d 508, 25 AFTR 97. Both cases affirmatively cited in *Smith-Bridgman & Co.*, 16 T.C. 287 (1951) at page 293, and in *Texsun Supply Corp.*, 17 T.C. 433 (1951) at page 445. The predecessor of Section 482 of the 1954 Act and Section 45 of the 1939 Act was Section 240(d) of the 1921 Act re-enacted in the 1924 and 1926 Acts. This Section appeared as a part of the consolidated returns provisions and permitted the Commissioner to "consolidate the accounts" of related trades and businesses for the purpose of making an accurate distribution or apportionment of income, deductions or capital. When the consolidated returns provisions were eliminated in the 1928 Act, it was felt that a similar policeman should be retained and Section 45 was enacted in substantially its present form. It was made clear that the new section was not intended to permit the consolidation of accounts. Many courts have seized upon this legislative history in adopting the general theme that Section 45 should apply merely to apportioning among members of the group true income or deduction items which the group has realized or incurred as respects outsiders. The general theme, therefore, is to the effect that Section 45 cannot be utilized to create income within the group or to disallow deductions since to do so would be washing out intercorporate transactions and would be requiring "consolidation of accounts."

[5] Footnote 4, above, but see *Welworth Realty Co.*, 40 B.T.A. 97 (1939), Acq. 1939, 2 C.B. 39 expressing a contrary principle.

[6] *Tennessee-Arkansas Gravel Co.*, footnote 3, above; *Smith-Bridgman & Co.*, footnote 3, above. The *Tennessee-Arkansas* case has generally been distinguished from *Asiatic Petroleum Co., Ltd.* (10 Cir. 1935), 79 F. 2d 234, 16 AFTR 610, affirming 31 B.T.A. 1152 (1935) cert. den. 296 U.S. 645, rehearing denied 296 U.S. 664 (1935), on the grounds that in *Asiatic Petroleum* real income had been created for the group since the securities which had been sold at cost by the taxpayer to a member of the group had been resold at market to outsiders after other intermediate sales within the group. See additional comment: Malcolm Johnson, "Intercorporate Lease and Royalty Arrangements," *Proceedings of New York University Ninth Annual Institute on Federal Taxation*, page 1187 (at page 1191, footnote 11), New York: Matthew Bender and Company, 1951.

Where one member of a controlled group owns property and leases to another member, Section 482 may not be used against the lessee member to decrease the rental deduction.[8] The use of this section does not include disallowance of a deduction, but merely permits distribution or apportionment of deductions.[9]

Rentals or royalties paid to an outsider by a member of a controlled tax group represents a true Section 482 case and may be apportioned among other members of the group benefiting thereby.[10] A rental deduction may be allocated among other members of the group where property leased from an outsider is used by such other members without paying their proportionate share of the rent.[11] The same results were reached where one of the affiliates paid rentals and royalties to an outsider for the use of intangible property and where the benefits from such intangible property flowed directly to other members of the group.[12]

Despite the general rule that Section 482 is inapplicable to purely intra-group transactions, there is some evidence of judicial erosion. In one case, the Commissioner was successful in increasing a low rental of property owned by a parent company and leased to a subsidiary.[13] In another instance, the Commissioner was unsuccessful in attempting to broaden the scope of Section 482 to include disallowance of a deduction by ignoring the corporate entity.[14]

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[7] *Waldo B. Russell*, par. 44,191 Prentice-Hall Memorandum T.C. (1944).

[8] *A. G. Nelson Paper Co., Inc.*, par. 44,286 Prentice-Hall Memorandum T.C. (1944).

[9] Footnote 10 infra; *General Industries Corp.*, 35 B.T.A. 615 (1937).

[10] *Southern College of Optometry, Inc.*, par. 47,079, Prentice-Hall Memorandum T.C. (1947). The Tax Court required that the rental be apportioned among affiliates, several tax exempt corporations, using the premises on the basis of rental space occupied by them, thereby reducing the petitioner's deduction. The court distinguished *Tennessee-Arkansas Gravel Co.*, footnote 3, above, noting that the situation was "not a case of attributing income where none exists," and then stating, "this proceeding involves only deductions, and it is an instance, not of disallowance but of true allocation." *Leedy-Glover Realty & Insurance Co., Inc.* 13 T.C. 95 (1949), affirmed (5 Cir. 1950) 184 F. 2d 833, 39 AFTR 1100.

[11] Footnote 10, as above.

[12] *Glenmore Distilleries Co., Inc.*, 47 B.T.A. 213 (1942); *Essex Broadcasters, Inc.* 2 T.C. 523 (1943). In the *Essex Broadcasters* case, apportionment on the basis of sales or receipts was approved, but in the *Glenmore Distilleries* case, it was disapproved because the expenses incurred did not benefit the subsidiaries pro rata. The method of apportionment should reflect the pro rata benefits resulting to each affiliate.

[13] *Welworth Realty Co.*, 40 B.T.A. (1939), Acq. 1939-2 C.B. 39. If the *Welworth* case were followed, it would result in creating income under Section 45. For a detailed analysis and criticism, see Malcolm Johnson, "Intercorporate Lease and Royalty Arrangements," footnote 6 above, p. 1187 (at pages 1195 through 1198), New York: Matthew Bender and Company, 1951. Compare with discussion by Samuel Joyce Sherman, "Section 45—A Case Study Analysis," *Proceedings of New York University Eighth Annual Institute on Federal Taxation*, p. 1257 (at pages 1280 and 1281) New York: Matthew Bender and Company, 1950.

[14] *A. G. Nelson Paper Co.*, par. 44,286 Prentice-Hall Memorandum B.T.A. (1944) where the activity of the lessor corporation was limited solely to holding the property used by other members of the group and where no independent income was derived from outsiders. In this case, premises were leased by petitioner from another corporation owned by the wives of the stockholders of petitioner, at a rental considerably in excess of that paid by the wives' corporation. The Commissioner attempted to disregard the wives' corporation since it had no other business activity, treating the husbands' corporation as the real lessee and limiting its deductions to rental and other deductions to which the wives' corporation was entitled. The Tax Court disagreed stating that it was not unusual for a company to limit its affairs to the sole purpose of acquiring premises for subleasing to known tenants. As to disregard of the corporate

More significantly, there has been an increasing effort to apply other sections of the Code to readjust distortions in rental and royalty arrangements. Although Section 482, when correctly applied, is not available to create income or disallow deductions within the group, controlled taxpayer arrangements must still stand up under other tests. This section is usually the entering wedge for applying these other tax principles to readjust the payment of rentals and royalties which are obviously excessive or low.

3. Section 162(a) (formerly Section 23(a)(1)(A)): Trade or Business Expenses[15]

Section 162(a) provides that deductions in computing taxable income shall include all ordinary and necessary expenses incurred in carrying on a trade or business including "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property" in which the taxpayer has no title or equity. While Section 162(a)(1) limits salary deductions to "reasonable allowances," no such statutory restriction exists with respect to rental or royalty deductions. After a period of confusion, it is now well settled that the statutory language of Section 162(a) per se does not limit "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property," to reasonable allowances.[16]

Although the law does not condition the deductions of rent or royalty on the reasonableness of the amount, the courts have developed certain negative and affirmative tests to deny deductibility to the extent that such payments for the use of property or intangibles are excessive. In cases denying deductibility, the courts first determine that such payments do not have the true character of rental or royalty,[17] or are not required for continued use or possession,[18] or have no valid business purpose,[19] or are not ordinary and necessary,[20] or are not made at arm's

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entity, see *National Carbide Corporation*, 336 U.S. 422, 37 AFTR 834 (1949) and Cleary, "Use of Subsidiary as an Agent after the National Carbide Corporation case," *Proceedings of New York University Eighth Annual Institute on Federal Taxation*, p. 48, New York: Matthew Bender and Company, 1950.

[15] No substantive changes have been made. The first sentence of subsection (a) corresponds to the first sentence of section 23(a)(1)(A) of the 1939 Code. The second sentence of subsection (a) is derived from the Legislative Judiciary Appropriations Act, 1954, and is inapplicable to subject matter discussed here.

[16] *Stanley Imerman*, 7 T.C. 1030 (1946), decided by the full bench of the Tax Court, established the "true character" test and rejected the "reasonable allowance" test; *Robinson Truck Lines, Inc.* (5 Cir. 1950) 183 F. 2d 739, 39 AFTR 788; *Stanwick's Inc.*, footnote 2 above. The term "other payments" in Section 162(a) includes royalties.

[17] Footnote 16, above.

[18] *M. Greenspun* v. *Commissioner* (5 Cir. 1946), 156 F. 2d 917, 35 AFTR 48; *Brown* v. *Commissioner* (3 Cir. 1950), 180 F. 2d 926, 39 AFTR 155, cert. den. 340 U.S. 814 (1950); *The Pennock Plantation, Inc.*, par. 51,341 Prentice-Hall Memorandum T.C. (1951); *Kirschenmann* v. *Westover* (D.C. Calif., June 30, 1952); *Consolidated Apparel Co.* v. *Commissioner* (7 Cir. 1953), 207 F. 2d 580; *Stanwick's Inc.*, footnote 2, above.

[19] *M. Greenspun* v. *Commissioner*, footnote 18, above; *Granberg Equipment, Inc.*, 11 T.C. 704 (1948); *Stanwick's, Inc.*, footnote 2, above; *Armston Co., Inc.* v. *Commissioner* (5 Cir. 1951) 188 F. 2d 531, 40 AFTR 460; *58th Street Plaza Theatre, Inc.*, 16 T.C. 469 (1951), affirmed *per curiam* (2 Cir. 1952), 195 F. 2d 724, 41 AFTR 1130; *Utter McKinley*

length.[21] These tests are negative. They explain what the payments are *not*. Usually, the courts proceed to explain what the payments *are*. The courts denying the deductibility view the payments as a dividend or distribution of profits,[22] gift,[23] capital contribution,[24] compensation, or loan.[25] These tests are positive.

The reasoning of the courts often combines several of the above negative tests.[26] However, the basic negative test is that of determining the "true character" of the payment. Section 162 itself supports the "true character" test. All rentals or royalty payments are not necessarily deductible. To be deductible, they must be "required to be made as a condition to the continued use or possession, for the purposes of the trade or business, of property, etc."[27] In determining if the "true character" of the payment is one such as is required for the continued use or possession of the property for purposes of the trade or business of the taxpayer, the reasonableness of the payment is necessarily a most important factor. Thus, while the "reasonable allowance" test alone is insufficient to disallow any rental or royalty deduction, the factor of reasonableness is significant in determining whether the real character of the payment is something other than rent. The mere fact that a rental or royalty payment is too high or too low is no reason to

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Mortuaries, par. 53,253 Prentice-Hall Memorandum T.C. 1953; *Consolidated Apparel Co.* v. *Commissioner*, footnote 18 above; *Riverport Lace Works, Inc.* T.C. Memo. 1954-39.

[20] *Rota Cone Oil Field Operating Co.* (10 Cir. 1948), 171 F. 2d 219, 37 AFTR 622; Stanwick's Inc., footnote 2 above; *Armston* v. *Commissioner*, footnote 19, above.

[21] *Stanley Imerman*, footnote 16, above; *M. Greenspun* v. *Commissioner*, footnote 18, above; *Henry G. Bender*, par. 47,108 Prentice-Hall Memorandum B.T.A. (1947); *Roland P. Place*, footnote 2, above; *Currier Farms, Inc.*, par. 48,188 Prentice-Hall Memorandum B.T.A. (1948); *Estate of Frederick W. Sullivan*, par. 51,236 Prentice-Hall Memorandum T.C. 1951; *Stanwick's Inc.*, footnote 2, above; *Hightower* v. *Commissioner* (5 Cir. 1951), 187 F. 2d 535, 40 AFTR 306; *Consolidated Apparel Co.* v. *Commissioner*, footnote 18, above; *Riverport Lace Works, Inc.*, footnote 19, above, in which the Tax Court, in denying the taxability of rental payments, sets forth the following factors considered in determining that the transaction was not entered into in good faith: (1) no business purpose, (2) the parties ignored the terms of the lease, (3) some rent was never paid, (4) obligation for rent bore no interest, (5) the new owners paid excessive compensation to the wives of the original owners, (6) the new owners subjected the property to a mortgage to secure the debt of the original owners, (7) after the sale and lease-back, the original owners continued to put more improvements in than the new owners, and (8) the purchase price paid by the new owners was considerably less than the market value.

[22] *Stanwick's*, footnote 2, above; *Limericks, Inc.*, 7 T.C. 1129 (1946), affirmed *per curiam* (5 Cir. 1948), 165 F. 2d 483, 36 AFTR 649; *Armston Co., Inc.*, footnote 19, above; *Floridan Hotel Operators, Inc.*, par. 53,050 Prentice-Hall Memorandum T.C. (1953); *Charlie's Cafe Exceptionale, Inc.*, par. 47,004 Prentice-Hall Memorandum B.T.A. (1947); *Granberg Equipment, Inc.*, footnote 19, above; *Ingle Coal Corp.*, footnote 2, above; *58th Street Plaza Theatre*, footnote 19, above; *Hightower* v. *Commissioner*, footnote 21, above.

[23] *White* v. *Fitzpatrick* (2 Cir. 1951), 193 F. 2d 398, 41 AFTR 492, cert. den. 343 U.S. 928 (1952); *Kirschenmann* v. *Westover*, footnote 18, above. In *Skemp* v. *Commissioner* (7 Cir. 1948) 168 F. 2d 598, 36 AFTR 1089, *Brown* v. *Commissioner*, footnote 18 above, and in *Consolidated Apparel Co.* v. *Commissioner*, the taxpayer sustained the validity of completed gift of property in trust so that the rental deduction claimed by each donor-lessee for the use of such property was not disallowed as a gift but allowed as rental or royalty. In *Stanley Imerman*, footnote 16, above, the Commissioner's brief urged that the amount paid was a gift.

[24] *Imperial Type Metal Co.* v. *Commissioner* (3 Cir. 1939), 106 F. 2d 302, 23 AFTR 347; *Louis E. Whitham*, par. 51,075 Prentice-Hall Memorandum T.C. (1951).

[25] *Roehl Construction Company, Inc.*, 17 T.C. 1037 (1951) disallowed salary payments and refused to label as rental where no such intention apparent; *Franklin Brown* 9 B.T.A. 965 (1927) held payment a loan.

[26] Footnotes, 17, 18, 19, 20 and 21, above.

[27] *Limericks, Inc.*, footnote 22, above.

readjust the payment unless its true character appears to be a dividend or some other form of non-deductible payment.[28]

While there are decisions still purporting to apply the rejected "reasonable allowance" test, an examination of these cases indicates that these courts made their decisions on affirmative grounds that the payment was a distribution of profits, or some other non-deductible item, in the guise of rent or royalty.[29]

The "continued use or possession," "business purpose," "ordinary and necessary," and the "arm's length" tests have been used separately and collectively to determine what in effect is the "true character" of the payment.[30] Successful application by the Commissioner of these tests says in different ways that the true character of the payment is not rent or royalty. After applying these negative tests, the courts show an increasing tendency to take a positive position that payments are in substance a distribution of profits or represent some other form of payment that is not deductible under the law.[31]

A review of the facts in cases involving rental and royalty arrangements establishes some guide posts to assist controlled taxpayers in framing their agreements. The controlled taxpayers are interested in having the Commissioner determine the negative tests in the affirmative—to the effect that the true character of the transaction is rental or royalty and deductible; and to determine the affirmative tests in the negative—to the effect that these payments are not a distribution of dividends or some other non-deductible items. A summary of these guide posts for establishing deductibility appears in Section 5 of this chapter.

4. Section 61(a) (formerly Section 22(a)): Gross Income Defined[32]

Rental and royalty arrangements among controlled taxpayers which involve a transfer and lease-back, in addition to being subject to attack under Section 482 and Section 162(a), may be challenged under the broad panoply of Section 61(a).

Typical transactions involve a gift or sale by one member of a controlled taxpayer group to a trustee for the benefit of other family members and a lease-back, or a direct transfer to the beneficiary and a lease-back.[33]

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[28] *Stanley Imerman*, footnote 16, above.

[29] *Limericks, Inc.*, footnote 22, above, is a typical example. See cases under footnote 22 above, but see Cyrus E. Newman, The Tax Liability of the Recipient of a Disallowance, "*Taxes—The Tax Magazine*," September 1950, Vol. 30, p. 811-815-7, indicating that the language of many of the courts would seem to place rents and royalties in the category of salaries.

[30] Footnotes 17, 18, 19, 20, and 21, above.

[31] *Stanwick's, Inc.* footnote 2, above, is a striking illustration of the tendency to first use the negative tests as an introduction to applying the affirmative test of a dividend or distribution of profits paid in the guise of rental or royalty. See cases under footnotes 22, 23, 24 and 25.

[32] No substantive changes have been made. The Report of the Committee on Finance, United States Senate, to accompany H.R. 8300, at page 168, states: "gross income includes 'all income from whatever sources derived. This definition is based upon the sixteenth amendment and the word 'income' is used as in section 22(a) in its constitutional sense. It is not intended to change the concept of income that obtains under section 22(a). Therefore, although the section 22(a) phrase 'in whatever form paid' has been eliminated, statutory gross income will continue to include income realized in any form. Likewise, no change is effected by the elimination of the specific reference to compensation of the President and judges of courts of the United States, and the compensation of such individuals will continue to be taxed in the same manner as that of other taxpayers. In view of the fact that certain types of income are excluded from gross income by other sections of the income tax subtitle of the new code, section 61(a) contains a clause excepting such income from the general definition of gross income."

These transfer and lease-backs are usually by prearranged plan. The transferor-lessee makes rental or royalty payments to a related transferee-lessor, or to a trustee for the benefit of members of the controlled taxpayer group, the object being for the high bracket transferor-lessee to obtain the deductions and for the low bracket transferee-lessor, or beneficiaries, to receive the taxable income.

Where the transferor-lessee controlled the trustee, he has lost.[34] Where he selected an independent trustee, he has won.[35] Whenever the transferor-lessee has demonstrated that he retained no control over the property transferred, he has been successful in obtaining a deduction for the rental or royalty paid. The courts have been consistently generous in permitting this deduction if the trustee is independent. The theory of these decisions is that even though a prearranged plan exists, the independent trustee is not controlled in making a lease-back, and may act for the exclusive benefit of the beneficiaries.

The Commissioner, however, has remained unwilling to accept taxpayers' victories. Where a transfer in trust for the benefit of members of the controlled taxpayer group is combined with a lease-back by a prearranged plan, the Commissioner has in a 1954 ruling (*see* footnote 35) asserted that the trustee is not independent and the transferor-lessee remains the owner. Under these circumstances, the Commissioner held that only a mere transfer of title occurs with control retained. The theory of this ruling is that the transferor-lessee has given up no real interest in his property and his business remains undisturbed. The Commissioner would deny the deduction and hold the so-called payments of rental and royalty to be gifts.

Strong editorial criticism leveled at taxpayers' continued success, supports the Commissioner's viewpoint.[36]

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[33] In *Skemp* v. *Commissioner*, footnote 23, above, *Brown* v. *Commissioner*, footnote 18, above, *Consolidated Apparel Co.* v. *Commissioner*, footnote 18, above, and *Albert T. Felix*, 21 T.C. 794 (1954), the taxpayer was successful in obtaining a deduction for rentals and royalties paid, by convincing the court the trustee appointed was independent; in the *Brown* and *Consolidated* cases the trustee was the taxpayer's attorney, and in the Skemp case, the trustee was a trust company; in *Kirschenmann* v. *Westover*, footnote 18, above, and the *Albert T. Felix* case, footnote 33 above, the taxpayer's brother was the trustee and the Court, therefore, determined that the taxpayer retained control over the trust res. The *Felix* case involved a sale, and the cases cited above in this footnote involved gifts. *White* v. *Fitzpatrick*, footnote 23, above, involved a direct gift by the taxpayer-husband to his wife, wherein the wife entered into a lease-back for "the full and entire term" of the patent, and since the husband could not operate his business without control of the patent and the premises, the court determined that he never intended to give up control.

[34] *White* v. *Fitzpatrick* and *Kirschenmann* v. *Westover*, footnote 23, above.

[35] *Skemp* v. *Commissioner*, footnote 23, above; *Consolidated Apparel Co.* v. *Commissioner*, footnote 18, above; *Felix*, footnote 33, above. The *Felix* case is the first instance of the tax court approving a transfer and lease-back from a trust for children. Faced with the *Brown, Skemp* and *Consolidated Apparel* Circuit Court reversals, the tax court was persuaded to allow the deduction for rental paid on property leased back from a trust for the benefit of taxpayer's children, and the Commissioner, without announcing whether or not he acquiesced in this decision, in Rev. Ruling 54-9, 1954 IRB No. 2 (p. 5) has asserted his disapproval of the Brown and Skemp doctrine, as being in conflict with *Helving* v. *Lazarus*, 308 U.S. 252, 23 AFTR 778, stating that where the lease-back is carried out under a "prearranged plan" that the "independence of the trustee in reality disappears . . . and the conclusion is, therefore, reached that under such circumstances, the donor-lessee remains the owner.

[36] William L. Carey: "Current Problems in Sale or Gift and Lease-back Transactions,"

In any event, the family transfer and lease-back should be utilized with caution, recognizing that any dominion retained by the transferor-lessee may be a sufficient basis for disallowance of the rental or royalty payments. The factors to be considered by the controlled taxpayer group in creating a transfer and lease-back are outlined in Section 5 of this Chapter.

5. Guide Posts for Establishing Deductibility

Enforcement of Sections 482, 162(a) and 61(a) of the Internal Revenue Code of 1954 to readjust or disallow deductions and income relating to rental and royalty arrangements among controlled taxpayers will not occur where the taxpayers deal at arm's length. Adjustment has been limited primarily to flagrant cases. None of these bases for attack will succeed if the transactions are reasonable under the particular circumstances.

The following "guide posts" are recommended to assist the controlled taxpayer group in establishing the validity of rental and royalty arrangements:

a. Relationship of taxpayers. Transactions between controlled taxpayers are subject to close scrutiny.[37] Eliminate the controlled taxpayer group from a dominating position in rental and royalty transactions and the basic reason for challenging the agreement is eliminated.

b. Books and records. Formalizing the arrangement by written agreement and adequate supporting records will not only assist the taxpayer in meeting the burden of proof required of him, but should also direct his attention to any weakness in his case. While an agreement need not be in writing, and its existence may be supported by other evidence, written or oral,[38] failure to enter into a written agreement, more often than not, results in the inability to prove the existence of any agreement.[39]

c. Expert testimony. Taxpayers have the burden of proof to sustain the payments as being rents or royalties.[40] Testimony by the president of a company as to reasonable rental value, where uncontradicted or unimpeached, may be sufficient without more to meet this burden of proof, but testimony by a secretary-

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Taxes—The Tax Magazine, August 1951, Vol. 29, p. 662; Roland K. Smith: "Shifting Income Within the Family Group," *Taxes—Tax Magazine*, December 1952, Vol. 30, p. 995; the latter article cites *White* v. *Fitzpatrick*, footnote 23, above, as justifying the conclusion that gift and lease-back transactions are subject to attack under the Clifford Doctrine. The following law notes: 59 *Yale Law Journal* 1529 (1950) and 51 *Columbia Law Review* 247, have criticized the use of a trust and lease-back as a tax avoidance device.

[37] *Stanwick's* footnote 2, above; *Ingle Coal Corp.*, footnote 2, above.

[38] *Differential Steel Car Co.*, 16 T.C. 413 (1951), acq. 1951-2 C.B. 2, in which there was no agreement in writing for many years, but when the agreement was formalized, it followed prior practices with schedules of royalties remaining constant; *Estate of Frederick W. Sullivan*, footnote 21, above.

[39] *Welworth Realty Co.*, footnote 13, above; *Stanwick's*, footnote 2, above; *Currier Farms, Inc.*, footnote 21, above; *Manos Amusements, Inc.*, par. 51,226, Prentice-Hall T.C. Memorandum, affirmed *per curiam* (6 Cir. 1953), 202 F. 2d 152; *Kerrigan Iron Works, Inc.*, 17 T.C. 566 (1951); *Riverport Lace Works, Inc.*, footnote 19, above.

[40] *Robinson Truck Lines, Inc.*, footnote 16, above; *Hightower*, footnote 21, above; *Manos Amusements, Inc.*, par. 49,278, Prentice-Hall Memorandum B.T.A., affirmed (6 Cir. 1950) per curiam 187 F. 2d 734, 40 AFTR 330.

treasurer who had a nominal interest was held to be insufficient.[41] Taxpayers would be better advised to offer disinterested expert testimony which takes into account, among other factors, the suitability of the rented property for a contemplated use, the nature of the construction on the property, availability of similar accommodations, comparable rents for similar localities and the type of property and improvements thereon and the fair return under the particular circumstances.[42] Avoid presenting conflicting expert testimony.[43]

d. Payment. Payment must be necessary and required,[44] and must be actually made.[45]

e. Method of rental determination. The terms and conditions of rental and royalty arrangements must be definite,[46] and not subject to change based on the lessee's willingness or ability to pay;[47] nor contingent upon profits;[48] nor may rentals be increased without being necessary and required as a condition for continued use;[49] nor may rents be established retroactively.[50] However, the amounts paid may be based on a reasonable percentage of gross sales, or some other variable type of rental,[51] provided such payments are not tied in with profits.[52]

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[41] *A & A Tool Supply Co.* v. *Commissioner* (10 Cir. 1950), 182 F. 2d 300, 39 AFTR 517; see *Robinson Truck Lines, Inc.*, footnote 42, above, where offering of president's testimony given similar importance, although two other witnesses' testimony was also offered; *Pennock Plantation, Inc.*, footnote 18, above.

[42] *Harry G. Bender*, par. 47,108 Prentice-Hall Memorandum B.T.A. (1947); *Roland P. Place*, footnote 2, above; *Estate of Frederick W. Sullivan*, footnote 37, above; *Consolidated Apparel Co.*, footnote 18, above.

[43] *Kerrigan Iron Works*, footnote 38 above; *Currier Farms, Inc.*, footnote 21, above.

[44] *Stanwick's Inc.*, footnote 2, above; *Skemp*, footnote 23, above; *Brown*, footnote 23, above; *Consolidated Apparel Co.*, footnote 18, above; *Thomas Flexible Coupling Co.* v. *Commissioner* (3 Cir. 1946), 158 F. 2d 828, 35 AFTR 606, cert. den. 329 U.S. 910 (1949), where deductions of royalties were denied because there was no legal obligation to pay, but after the State court ruled that the taxpayer was legally obligated to pay royalties to its stockholders, the Tax Court allowed and the Third Circuit affirmed taxpayer's deduction of payments in *Thomas Flexible Coupling Co.* v. *Commissioner* (3 Cir. 1952), 198 F. 2d 350, 42 AFTR 498; *Manos Amusements, Inc.*, footnote 39, above.

[45] *Dr. V. S. Gaggin*, 3 B.T.A. 19 (1925); *Orange & Domestic Laundry Co.*, 6 B.T.A. 646 (1927); *Riverport Lace Works, Inc.*, footnote 19, above; in *Welworth Realty Co.*, footnote 13, above, rentals were not paid in cash but merely credited on lessee's books and then adjusted yearly at lessee's discretion.

[46] *Stanley Imerman*, footnote 16, above; *Manos Amusements, Inc.*, footnotes 39 and 40, above; *West Virginia Tractor & Equipment Co.*, T.C. Memo. 1954 —, No. 37,517.

[47] *M. Greenspun*, footnote 18, above; *Floridian Hotel Operators, Inc.*, footnote 22, above; *Welworth Realty Co.*, footnote 13, above.

[48] *Differential Steel Car Co.*, footnote 37, above; *Shirley* v. *O'Malley* (D.C. Nebraska Division, 1950) 91 F. Supp. 98, 39 AFTR 723; *Estate of Frederick W. Sullivan*, footnote 21 above.

[49] The *Pennock Plantation, Inc.*, footnote 18, above; *Kirschenmann* v. *Westover*, footnote 18, above; *Roland P. Place*, footnote 2, above. Instead of simply increasing the rental of an existing lease, taxpayers have frequently sought the same result by either cancelling an existing lease and substituting a new lease more favorable to the lessor, or by having the taxpayer as lessee create a sub-lease to siphon off income to the sub-lessee. See *Charlie's Cafe Exceptionale*, footnote 22, above, and *Stanwick's Inc.*, footnote 2, above. In *Consolidated Apparel Co.*, footnote 18, above, the Seventh Circuit allowed the deduction, even though the existing lease was cancelled on the grounds that the action was taken by an independent trustee, and because a contemplated expansion program made it advisable to extend the period allowed in the former lease.

[50] *Granberg*, footnote 19, above; *Floridian Hotel Operators*, footnote 22.

[51] *Imerman*, footnote 16, above; *Estate of Frederick W. Sullivan*, footnote 21, above; *Essex Broadcasters*, footnote 12 above, upheld the division of costs based on each taxpayer's volume of sale.

[52] *Floridian Hotel Operators*, footnote 22, above; *Shirley* v. *O'Malley*, footnote 48, above; in *Differential Steel Car Co.*, footnote 38, above, the taxpayer was victorious where payment was not dependent on profits, except where such payments would be a severe hardship on lessee.

f. Reasonableness. If the true character of payments made is to be considered as rental or royalty, the payments must be reasonable, but to be reasonable, payments of rental or royalty should be in such amounts as a lessor dealing at arm's length with a lessee, neither being under compulsion, might reasonably charge, at the time of making the lease or royalty arrangement.[53]

g. Business purpose. Establishing a legitimate business purpose may make an otherwise invalid transaction acceptable. Impairment or lack of credit, expansion of a business operation, have been held to provide a sufficient business purpose.[54]

h. Special circumstances. Related to business purposes above are unique conditions or special circumstances of each transaction which may be decisive in the determination that the deductions claimed are reasonable. Among the special circumstances assisting the controlled taxpayers in establishing the fairness of a transaction in which the payment of rent or royalty might otherwise appear to be unreasonable, are the following: no comparable property available, high cost of moving or building, change in character of neighborhood or property, and the particular use of the property.[55]

i. Control. Where there is a sale and lease-back, or a gift and lease-back,[56] retention of dominion or control in the seller or donor will result in disallowance of a deduction for rental or royalty. Where the transfer is in trust, the question of retention of control has been determined by the courts primarily on whether or not the trustee is independent. Where the trustee was not independent (being a brother of the donor), the taxpayer lost,[57] and where the trustee was independent (being a trust company or donor's attorney), the taxpayer won.[58] However, the Commissioner has given fair warning that where there is a prearranged plan, he will not consider the trustee as being independent. In other controlled taxpayer situations not involving lease-backs, where the lessor acts unilaterally to reallocate funds within the family group and the lessee acquiesces in the lessor's dominion, the courts have denied rent and royalty deductions.[59]

The cases cited in connection with the above paragraph indicate that the following elements are significant in determining the question of control among related taxpayers: maintenance of the office books and records, hiring of employees, establishing management policies, division of management responsibilities, origin of capital and basis for financial credit. Perhaps of greater significance is the use of these factors of control in planned, integrated steps to accomplish a spreading of income among the controlled group. The necessity of establishing independence of action by each member of a controlled group is fundamental to insure deductibility of rent or royalties in transactions among a controlled taxpayer group.

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[53] Cases finding payments reasonable include *Imerman*, footnote 16, above, *Bender*, footnote 42, above, *Differential Steel Car Co.*, footnote 37, above, *Estate of Frederick W. Sullivan*, footnote 21, above, *West Virginia Tractor*, footnote 46, above, and *Sears Magnetic Mfg. Co.* (7 Cir. 1953), 208 F. 2d 849, reversing and remanding, par. 52,160, Prentice-Hall Memorandum T.C. 1952. Cases finding payments unreasonable include *Place*, footnote 2, above, *The Pennock Plantation, Inc.*, footnote 18, above, *Currier Farms*, footnote 21, above, and *Charlie's Cafe Exceptionale*, footnote 22, above; *Riverport Lace Works, Inc.*, footnote 19, above.

[54] *West Virginia Tractor Co.*, footnote 46, above; *Consolidated Apparel Co.*, footnote 18, above; *Stearns Magnetic Mfg. Co.*, footnote 46, above.

[55] *Estate of Frederick W. Sullivan*, footnote 21 above; *Bender*, footnote 42, above; *Limericks, Inc.*, footnote 22, above. For cases where special circumstances worked against the taxpayer, see *Kerrigan Iron Works*, footnote 39, above, and *Raymund M. Cassidy*, par. 51,182, Prentice-Hall Memorandum, T.C. (1951).

[56] *Shaffer Terminals, Inc.*, 16 T.C. 356, affirmed *per curiam* (9 Cir. 1952), 194 F. 2d 539, 41 AFTR 847; *Armston Co.*, footnote 19, above; *White* v. *Fitzpatrick*, footnote 23, above; *Kirschenmann* v. *Westover*, footnote 18, above.

[57] *Kirschenmann* v. *Westover*, footnote 18, above.

[58] *Skemp*, footnote 22, above; *Brown*, footnote 18, above; *Consolidated Apparel Co.*, footnote 18, above; *Felix*, footnote 33, above.

[59] *Floridian Hotel Operators, Inc.*, footnote 22, above; *Place*, footnote 2, above; *Manos Amusements, Inc.*, footnotes 39 and 40, above.

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Financing by Using Stocks or Bonds

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Simply stated from a business and investment viewpoint, corporate financing merely involves the meeting of minds of the corporation and the investor as to the amount of corporate funds needed, the duration of time for the corporation to retain the money advanced, and the terms upon which the financier will permit the corporation to use his money for such period. Although, in the main, these considerations will always be present, high tax rates require the transaction to be cast in such manner as to result in desired tax consequences. Normally, the taxpayer-financier requests an opportunity to gather in his profit at capital gain rates while the corporate user of funds would appreciate the chance to deduct from its ordinary income any amount it pays, or is obligated to pay, in excess of the sum advanced. In many instances an investor merely desires portions of his investment returned without tax and considers such result a sizable, as well as beneficial, accomplishment. As might be guessed, the identity of the corporation, i.e., whether publicly or closely held, and the position of the investor, i.e., whether a stockholder or lender, may prove the decisive factor in arranging a transaction.

1. Points to Consider

Section
Short-term loans 2
Long-term financing 3
Closely held corporations 4
    How to determine inadequate or thin capitalization
    How to treat loans by third parties
    Miscellaneous factors

2. Short-term Loans

Sometimes a method of corporate financing may be blessed by a mistaken notion of investors as to the tax advantages inherent in the transaction. The sale of commercial paper in the open market by corporations desiring short-term loans has been of diminishing importance and volume in the last twenty years. Prior to the enactment of the 1954 Code, which clearly defines what is ordinary income on indebtedness issued after January 1, 1955, the amount of borrowing by the sale of short-term notes at a discount from face had recently risen considerably, and one explanation given for this renewed interest is that purchasers who acquire promissory notes with a maturity of more than six months consider the difference between the purchase price and face value as long-term capital gain.[1] Since these notes are neither registered nor with coupons attached, there is no question that when the corporate borrower pays the note the lender realizes ordinary income because of there being no sale or exchange.[2] However, what happens if the investor holds commercial paper over six months and then sells to another investor —is he still considered to have received ordinary income measured by his profit?

This precise question was presented to the Bureau for a ruling concerning whether an investor in commercial paper maturing in nine months who held said paper over six months and sells, has a capital gain or ordinary income. The Bureau considered the difference between issuance price and face value at maturity to represent interest since the discount was in fact compensation paid for the use or forbearance of money. Consequently, when the holder sells the paper prior to maturity any profit attributable to the discount is treated as realization of interest and therefore as ordinary income.[3]

Accordingly, the use of ordinary commercial paper to obtain capital gain would not seem to have much chance of success. In order to escape the aforementioned results, there is the possibility that short-term notes, if registered, may give rise to capital gain upon redemption. Section 117(f) of the Internal Revenue Code of 1939 provides that amounts received upon the retirement of registered notes shall be considered as amounts received in exchange therefor. Consequently, it is not surprising that commercial paper issued after the Bureau Ruling tends more and more to be in registered form. Although the shorter the term of the note the more obvious it is that the discount represents interest, yet the Statute clearly provides that amounts received upon redemption of registered notes are to be treated as capital gain. In a previous case, the Court held that a long-term registered bond, bearing no interest but having a maturity value based upon the issuance price at cumulative interest of 5½ per cent, results in capital gain to the holder upon redemption even though the gain actually represents interest.[4] In fact, the Court stated that "it is difficult to perceive any practical reason for taxing increment of the type involved here differently from ordinary income. The fact that the contract does not provide for equal amounts of interest to be set aside each year, available to the holder, does not affect the question. The increment is consideration paid for the use of the principal sum. *Unfortunately for the Commissioner's contention, Congress has not made the differentiation.*" Since the statute is held to apply irrespective of the true nature of the gain, the courts may be hard put to distinguish between registered notes based upon the length of the obligation.[5]

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[1] See "New Life for an Ancient Market," *Business Week*, November 8, 1952, page 168. Although the article reports that corporate buyers have this tax angle, it is improbable that an accrual basis taxpayer could avoid accruing the increment as interest where a discount bond is issued directly to it.

[2] *McClain* v. *Commissioner*, 311 U.S. 527 (1941).

[3] Special Ruling issued February 17, 1953. See also *F. Rodney Paine*, 23 T.C. 391 (1954).

[4] *Caulkins* v. *Commissioner* (6th Cir., 1944) 144 Fed (2nd) 482.

[5] However, the Bureau does not seem to have had any trouble in distinguishing the 12-year Israeli bonds from the bonds in the *Caulkins* case. In Revenue Ruling 119 the Bureau held such bonds not within the purview of Section 117(f). While the Bureau may reasonably adopt

The Internal Revenue Code of 1954 leaves unanswered the questions raised above as to indebtedness issued before January 1, 1955. Accordingly, under Section 1232 of the 1954 Code, as to evidences of indebtedness issued before January 1, 1955, the old law applies, provided that bonds were issued with interest coupons or in registered form or at least in such form on March 1, 1954.

As to evidences of indebtedness issued on or after January 1, 1955, there is no need for such instruments to have interest coupons or be in registered form. However, the law specifically provides that any gain attributable to the original issue discount of a certificate of indebtedness will be treated as ordinary income to the holder for the allocable period that he held such indebtedness.

3. Long-term Financing

The publicly held company in search of funds must determine whether to float a loan or sell equity issues. If it incurs indebtedness, then there is an annual charge against its earnings or operations with a fixed maturity date for the principal payment. On the other hand, existing stockholders may prefer the leverage afforded by debt rather than the sharing of all profits and increase in value with new investors. Of course, investors may be given an additional incentive by lending money with all the safeguards attendant upon the creation of an indebtedness plus an additional feature permitting the lender to convert into an equity security. Obviously, the terms and conditions of these various transactions depend upon market negotiations and the situation of each corporation and the desires of its stockholders.

The Revenue Code of 1954 will not have an appreciable effect upon the desires of investors. Although Section 116 of the Code grants an exemption from tax of $50 of annual dividend income and Section 34 gives stockholders a credit against tax of 4 per cent of the taxable dividend income, the amounts saved are rather insignificant in comparison with the corporate inability to deduct dividend payments at a 52 per cent rate.

4. Closely Held Corporations

How to capitalize a closely held corporation to obtain the maximum tax advantage is a problem of increasing importance. When financing a closely-held corporation, it is normally desirable for stockholders to make their contributions in the form of loans to the greatest extent possible;[6] however, a point may be reached where, despite all indicia of indebtedness, the amounts advanced as loans may be so great relative to the stock contribution that the loans will be treated

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this conclusion, it is entirely unsupportable for it to acquiesce in the *Caulkins* case and, at the same time, issue rulings exactly contrary to the principles enunciated in such case. (Since the writing of this article, the Bureau has withdrawn its acquiescence in *Caulkins*.)

[6] The holder may receive payment of loans without tax; the corporation may deduct interest, not dividend, payments; the corporation may set aside funds to pay the debts and therefore have a good reason for accumulation of earnings; see Schlesinger "'Thin' Incorporations—Income Tax Advantages and Pitfalls," *Harvard Law Review*, November 1947, Vol. 61, Page 50. See also, for usual conditions of borrowing, Guthmann & Dougall, *Corporate Financial Policy*, 240-250, Prentice-Hall, Inc. (1948).

like an equity investment.[7] It is necessary to examine key cases in order to be able to prophesy with some degree of certainty the point at which a "loan" will turn into a capital investment.

How to determine inadequate or thin capitalization. It is rare for a judicial dictum to set a firm base for a doctrine that had previously been advanced sporadically in only a few cases. Yet, in a case in which the factor of undercapitalization had not been considered by the lower court, the United States Supreme Court set the trend for judicial and administrative emphasis upon inadequate capitalization by the following meaningful dictum: "As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure." [8] The few cases before, and the growing number of cases subsequent to, this dictum, have indicated two reasons for treating corporate indebtedness as capital investment:

1. So-called interest on the loans are received by the same persons who are entitled to dividends on the equity securities they hold.
2. The loans are at the risk of the business the same as any capital investment, since the loans represent the only assets held by the corporation.

The early cases set forth these reasons clearly, while the more recent cases accept the doctrine of inadequate capitalization and apply various criteria to determine whether to apply this principle to the facts at hand. As examples of the early cases are *Edward S. Janeway*[9] and *Michael Cohen*.[10]

In the *Janeway* case, the taxpayers and others advanced money to a corporation and in return received corporate notes and 6/10ths of a share of stock for each $1,000 advanced. The corporation had no other assets or capital except these advances. Upon dissolution of the corporation, the taxpayers contended that the loss sustained upon the notes represented bad debts. The Tax Court held, however, that the notes were to be considered as shares of stock, and stated:

> Not only are the petitioners not mere creditors, but also stockholders. . . . Though, as petitioners argue, it was their intention to receive notes for the money paid out by them, it was also their intention to receive, and they did receive with the other stockholders in like position as to advancements, the entire issued capital stock of the corporation and all the control and value it entailed, in proportion to the money which went into the corporation. Though the advances made were, by the issuance of the notes, given the appearance of loans, the possibility of repayment was no stronger than the business and its possible success. No other money was paid in for stock, so that the advances constituted the corporation's only source of working capital. . . . The effect of what was done is the same as if the petitioners and the other stockholders purchased the stock with the money advanced, and became pro rata owners of the corporation.[11]

An issue similar to the one decided in the *Janeway* case appeared in *Michael Cohen.* In this case the taxpayers invested $1,000 in the capital stock of a corporation and "lent" it $14,000. The Commissioner contended that the entire $15,000 represented a capital investment. The court agreed with the Government, stating:

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[7] See Semmel "Tax Consequences of Inadequate Capitalization," *Columbia Law Review,* March 1948, Vol. 48, Page 202; Loan Versus Investment—Inadequate Capitalization" *Tax Law Review,* March 1950, Vol. 5, Page 424.

[8] *John Kelley Co. v. Commissioner,* 326 U.S. 521 526 (1946).

[9] 2 T.C. 197 (1943), affirmed (2nd Cir., 1945) 147 (2nd) 602.

[10] T.C. par. 44,084 Prentice-Hall Memorandum (1944), affirmed (2nd Cir., 1945) 148 Fed (2nd) 336.

[11] 2 T.C. at page 202.

> Clearly all monies advanced by the petitioners to the Edward Development Corporation were at the risk of the business. The corporation had no assets besides the $15,000 that was put into it by the petitioners. . . . No differentiation can be made between the amounts invested in the stock of the corporation and the loans to the corporation.

In *1432 Broadway Corporation,*[12] real estate and a sum of $40,000 was transferred to the taxpayer-corporation for all of its 390 shares and debentures in the face amount of $1,170,000. The property was worth at least $1,200,000, but there was a mortgage on it in the amount of $300,000. The taxpayer-corporation attempted to accrue interest due on the bonds in order to obtain a deduction, while the Government claimed that the debentures represented a capital contribution and that the so-called interest was actually a dividend. The court agreed with the Government's contention, stating:

> The debentures are in approved legal form . . . But, for tax purposes, their conformity to legal forms is not conclusive. Although the taxpayer has the right to cast his transactions in such form as he chooses, and the form he chooses will generally be respected, the Government is not required to acquiesce in the taxpayer's election of form as necessarily indicating the character of the transaction upon which his tax is to be determined . . . The distribution of the rent income whether with interest or principal on debentures or dividends on shares, would go to the same persons in the same proportion, since each had the same proportionate number of both, and it would matter not to them whether the distribution was called dividends or interest.[13]

Soon after the Supreme Court dictum, as demonstrated by the *Mullin Building Corporation*[14] and *Swoby Corporation*[15] cases, the courts began to stress the comparative amounts invested in the corporation as against the amount lent.

In *Mullin Building Corporation,* a real estate corporation was formed with 100 shares of common stock and 2,900 shares of debenture preferred stock, all of the par value of $100 per share and held by the same people proportionately. The corporation claimed that the debenture stock represented indebtedness. The Court held the debenture to be capital stock pointing out that "interest" could only be paid out of earnings. Further, "it was not necessary to create a 29 to 1 debt to capital ratio in petitioner's financial structure . . ." Clearly, it is never necessary for a closely held corporation to have the indebtedness overshadow the capital investment.

In *Swoby Corporation* the taxpayer was formed to acquire real estate and it issued therefor 200 shares of capital stock of the par value of $1.00 per share and a single 99-year "Income Debenture" of the face amount of $250,000. The question arose whether the debenture was actually a capital investment. The Tax Court so held, and applied the Supreme Court's warning to its facts, stating:

> Dealing with property having a stipulated value of "at least $250,200," the financing selected was to create a clearly "nominal" figure of $200 in the common stock and "an obviously excessive debt structure" of $250,000 in the debenture.

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[12] 4 T.C. 1158 (1945), affirmed (2nd Cir., 1947) 160 Fed (2nd) 885.

[13] *Id.* at page 1165.

[14] 9 T.C. 350 (1947), affirmed (3rd Cir., 1948) 167 Fed. (2nd) 1001.

[15] 9 T.C. 887 (1947).

As of today, it would seem that the proper way to capitalize a corporation is to advance to a corporation no more than four dollars to every dollar invested in equity capital. This ratio is presently the safest limit of indebtedness as indicated in a recent Tax Court case acquiesced in by the Commissioner. In *Ruspuyn Corporation*,[16] real estate was incorporated and the corporation issued $600,000 of stock and $2,100,000 of 6 per cent bonds, maturing in 80 years, for the property worth $2,700,000. The Court respected the indebtedness, stating:

> The ratio of debt to equity investment was only three and one-half to one, whether taken on the basis of face and par value or on the basis of actual value. In view of the substantial equity investment in petitioner and a ratio of debt to equity investment of only three and one-half to one, the situation is as favorable to petitioner as that involved in *Kelley* v. *Commissioner*, 326 U.S. 521, where the ratio of debt to stock was four to one.

How to treat loans by third parties. There are two problems involving third parties and undercapitalization which have been raised but not entirely answered: (a) Are loans from outsiders to be added to corporate indebtedness in order to determine whether the stockholders have not contributed sufficient capital and (b) Are loans which are treated as capital in the hands of stockholder-creditors to be considered as indebtedness when transferred to third parties.

a. *Third party loans.* In *Isidor Dobkin*,[17] a corporation was organized to acquire a building at a price of $72,000. There were first and second mortgages outstanding of $44,000, and $28,000 was thus needed to make up the difference. The investors put $2,000 into corporate stock and lent the corporation $26,000. The Tax Court treated the loan of $26,000 as additional equity capital, stating:

> Taking into account the $44,000 of first and second mortgages, the effect of this [loan] designation was to give the corporation a debt structure of $70,000 as against a capital stock investment of $2,000, or a ratio of 35 to 1 of indebtedness to capital stock.

However, it cannot be taken as certain that third party loans are to be included since, without such debt in the *Dobkin* case, the ratio would still have been 13 to 1 of debt to capital. In a recent case, *Gazette Telegraph Co.*,[18] the Tax Court respected stockholders' loans of $250,000, where there was $250,000 in stock, and bank loans of $410,000, but gave no indication of final acceptance of the *Dobkin* rule, stating:

> The question of "thin" capitalization is raised by respondent, but if we bring in the Bank of America obligation the ratio of equity to indebtedness is approximately 1 to 2½ and if we count only the notes issued to shareholders that ratio is 1 to 1. We do not think this case can be made to rest on "thin" capitalization.

b. *Transfer of "tainted" loans.* Taxpayers have argued that bonds should be respected as true loans, despite inadequate capitalization, because even where the bonds are held in proportion, the bonds are still transferable and outsiders holding such bonds would be considered as true creditors. Therefore, continues the argument, since the bonds are transferable while held by the stockholders, the latter should also be considered as creditors since the character of the certificates should not change merely because different parties may hold them. This argument, however, has not been adopted, the Court stating in the *1432 Broadway Corporation* case:

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[16] 18 T.C. 769 (1952) (acq.).

[17] 15 T.C. 31 (1950), affirmed (2nd Cir., 1952) 192 Fed (2nd) 392.

[18] 19 T.C. No. 86 (1953).

> It is idle to argue that the debentures were transferable and must therefore be judged separately from the shares, for they were issued to the same persons as held the shares, and in the same proportion, and they were not in fact transferred.[19]

If the stockholders sell their entire bondholdings to outsiders, there would be no justifiable reason to refuse to treat the bonds as representing a valid corporate indebtedness, the same as if the bonds had been originally issued by the corporation to the purchaser. This problem arose in the *Gazette Telegraph Co.* case, where the stockholders owed a bank and the bank received corporate notes in payment of the debt. At first, the Government argued that the interest paid to the bank was not deductible, but on brief the Government conceded the point. Accordingly, so long as the loans are truly purchased by the outsider and represent corporate indebtedness and not stockholders' indirect debts, the loans should be respected, even though considered risk capital while held by the stockholders.

Miscellaneous factors. Even though a corporation may be undercapitalized, loans having indicia of indebtedness may still be considered as debts if (a) the loans of the stockholders are disproportionate to their stockholdings or (b) the loans were made at a date subsequent to the original incorporation.

a. *Disproportionate loans.* Where the loans by stockholders are truly disproportionate to their stockholdings the Commissioner will recognize the indebtedness. This result should obtain, since the interest on the loans, or the repayment thereof, is not to any substantial extent a substitute for dividends on stock. In addition, the return on the loans is not geared to the element of risk nor do the holders necessarily have equity control.

However, if the disproportion is insignificant, or results from gifts of notes, it would not seem likely that the loans would be respected if they would otherwise have been considered as equity capital. Yet, in *Arthur V. McDermott*,[20] the Tax Court seemed to recognize what appears to be insubstantial variations of ownership in the light of all the facts.

In the *McDermott* case, eight children inherited some real estate and transferred it to a corporation for a recited consideration of $108,418. Each child received notes in the face amount of $12,500, and three of the children received additional notes aggregating $8,418, constituting a total indebtedness of $108,418. No reason was given why three of the children were given more notes than the others. In addition, each of the eight transferred miscellaneous assets aggregating $5,533.36, in exchange for five shares of stock. The record fails to indicate whether the eight each contributed equally to the stock. No dividends were ever paid by the corporation, and no shares of stock were sold.

The corporation was later liquidated and the taxpayer, one of the eight heirs, claimed a bad debt deduction for his notes. The Commissioner contended that any loss thereon was a capital loss.

The Court did not deem the "loans" to represent capital contributions, advancing as one reason for its conclusion that the loans were not held in "exactly" the same proportions as the stock. This result may not stand up under analysis, since no explanation was given by the taxpayer for the disproportionate holdings of the loans. Actually, this disproportion may have been the result of gifts by five of the children to the other three. Furthermore, the disproportion may have been so slight as to be *de minimus*, and the Court should have considered whether the disproportion was substantial enough to be a factor.

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[19] 4 T.C. at page 1166.

[20] 13 T.C. 468 (1949) (acq.).

b. *Subsequent loans*. Where the proportion of indebtedness to capital is fixed at the outset of corporate operations, the courts have no trouble in applying the rules evolved concerning undercapitalization. And where the stockholders form a corporation knowing that more funds would be required at a later time, then future advances are treated as though part of the corporation's original financing. But where a corporation is adequately capitalized at its inception, and later events, such as needs for expansion, result in a requirement of more corporate funds, the courts have not clearly enunciated any rule as to how to measure the additional advances in the light of the existing capital structure.[21] It would seem that the courts should measure the new losses against the value of the business to determine whether the loans are additional equity capital or true indebtedness. In order to avoid this problem, stockholder-lenders should take some additional stock if necessary to maintain the proper relationship of debt to capital.

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[21] Compare *Powers Photo Engraving Co.*, 17 T.C. 393, affirmed (2nd Cir., 1952) 197 Fed (2nd) 704 with *Earle* v. *Jones & Son, Inc.* (9th Cir., 1952), 200 Fed (2nd) 846.

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How Businessmen Should Buy Property

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The acquisition of business assets or of an entire business is logically first weighed as a serious economic risk, although frequently determined by tax advantages. The tax problems arising in the purchase or sale of business property to confront the seller or the buyer are often so distinct and separate that rarely can one find a pattern or approach into which both parties will fit—or reach complete satisfaction and accord. Sometimes the details of a business transaction are nearly complete before the tax implications are recognized. Experiences in recent years with our *complex* and *burdensome* tax structure clearly teach both the prospective buyer and seller that the problems inherent in these transactions should never be concluded without benefit of competent tax counsel. The purchase of business property should not be based *exclusively* on tax considerations; the decision to purchase properties—or not to—motivated solely by tax consequences, may conclude with regrettable results.

Transactions of this kind usually afford opportunities for ethical tax savings and they must be grasped immediately, or perhaps never. Here we assume your client is the buyer—although invariably you will consider the problems of both. A tax saving to the seller may afford the buyer a better price—a tax advantage for one party may augur a more favorable price for the other. Your problem is likely to be a dual one: to work out a method to the advantage of both parties—so you will surely reach the point of looking at *both* sides.

The practitioner's problem is to consider alternative routes—concluding with a choice for maximum tax economy. There is ample judicial authority to support the premise that taxpayers are not required to transact business, or to arrange their affairs, by means which do not save taxes.

By properly directing the transaction, for either buyer or seller, you may effect a tax reduction, a reduced cost, or increased profit, all within the lawful and moral right of tax avoidance. The buyer's problems—usually fewer than the seller's—are described in this chapter.

1. Points to Consider

Assume your client is considering the purchase of business property, or an entire business. Your problem is to discover the best means by which to accomplish this objective while preserving the most satisfactory tax consequences for him. Your first consideration will concern the nature of the asset desired.

	Section
(a) How to acquire a single business asset:	
Tangible:	
inventoriable	2, 5
depreciable	2
land (not recoverable as a wasting asset)	2
Intangible:	
amortizable (patents, leases, contracts)	2
(b) How to make a lump sum purchase of several assets and avoid goodwill	3
(c) How to purchase an entire business:	
Incorporated	4
Unincorporated	5

Each successive step or objective will involve more complex tax planning; that is, (b) over (a) for allocation of values; (c) over (b) if necessary to buy capital stock or partners' interests.

	Section
To decide the best means of purchase: in (a)	2
in (b)	3
To decide the safest method to buy stock solely to obtain assets in (c)	4

When it is decided to acquire a single asset, several assets in a bulk purchase, or the entire business as a unit, you will be faced with either choosing a method of purchase, or of allocation of values. Either of these may be altered by reason of the effect upon the seller's tax position. For instance, the acquisition of an entire business, standing alone, is not a simple problem. Shall it continue its course with new owners or new stockholders? Shall it lose its separate entity (by dissolution), emerging with the desired assets (and the desired basis) available for use in a new corporate vehicle, or be merged with an existing business? The tax consequences may be far reaching. The important thing is that we have before us reminders of the points to be watched and their tax effect upon either purchaser or seller. A few are:

	Section
How to allocate and seek values for separate pieces in bulk purchases	3, 5
How and when tax advantages now held by the seller should be preserved	4
How to use covenants not to compete	6
How and when to use lease agreements with options to purchase	7
When to consider deductions for use of property instead of purchase	2, 8
How to treat later reduction in purchase price of property	9

2. How to Acquire a Single Piece of Business Property

Compared to the seller, the buyer will usually have little concern as to whether the asset will qualify as a "capital" asset. It is self-evident that a buyer has no problem in the simple purchase for cash of a piece of property. The nature of the asset or the manner of purchase may afford—or deny—some tax advantage sought by the buyer. He will want the quickest recovery of his cost through deductions for tax purposes; i.e., *the return of his capital in the shortest possible period*. The problems of buyers of business properties may be stated in three general divisions: (a) to buy corporate assets or purchase stock; (b) to buy partnership assets, or acquire the partners' interests; (c) to buy individual assets, or assets in a lump sum —followed by allocation of that sum to the assets.

We will consider division (c) first. Properties frequently bought separately rather than as a part of a business unit or going concern are: real property; property under a long-term lease; machinery, equipment, etc.; patents, franchises, and similar amortizable intangibles. A purchaser of land, buildings, and improvements thereon for a *lump sum* should carefully consider his allocation to the separate items and work this agreement out with the seller. Since no tax deductions may be had from land, you would try to place the *lowest* realistic value thereon. A careful estimate of the life of buildings and building improvements should be made, preferably by one or more competent appraisers with knowledge of commercial properties, to form a basis for future depreciation. Improvements, such as artificial lakes, spillways, driveways, parking lots, and spur tracks may have shorter lives for recovery of cost through periodic deductions.

If the investment can be denominated as an "improvement" used in a trade or business, it may be subject to depreciation regardless of who owns the fee title. In *Thomas J. McGinty*,[1] the cost of materials and labor to build up land, level a race-track, and provide roads and parking space for customers was held recoverable through depreciation.[2]

Generally, taxes are deductible only by the person upon whom they are imposed. Under the law prior to 1954, unpaid local property taxes which became a lien while title was in the seller's name were not deductible by the buyer when assumed and paid by him. Instead, such taxes were capitalized as added cost of the property. This is true because the deduction for taxes depended upon the *time* when the tax becomes a lien upon the property.[3] Where, for example, the tax lien attached to the property *before* the date of sale, only the seller would be allowed a deduction of the tax for income tax purposes, regardless of the manner in which the sales contract may have allocated the tax between them. The Internal Revenue Code of 1954 has corrected this situation by providing that the purchaser and seller of real property may *each* claim a deduction for that part of the property tax which is proportionate to the number of months in the *property tax year* during which he held the property. Example: property assessment date January 1, sales date June 30, seller will deduct one-half of taxes imposed, buyer the other half, and this provision of allocation applies whether or not the parties to the transaction actually apportioned the tax in the written contract. This rule permits the *cash basis tax-*

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[1] Par. 44,270 Prentice-Hall Memorandum T.C. (1944).

[2] The case cited: *L. Z. Dickey Grocery Co.*, 1 B.T.A. 108 (1924), cost of private roads giving access to a store was subject to depreciation; *Lord & Bushnell*, 7 B.T.A. 86 (1927), cost of filling and grading to construct railroad tracks and plank roads over swampy land was an expenditure subject to depreciation; E. W. *Edwards & Son* v. *Clark*, 29 F. Supp. 671, D.C. N.D., N.Y. (1939), a tunnel constructed (under a public road) between two buildings used in the business was subject to depreciation.

[3] *Commissioner* v. *Robert LeRoy* (2 Cir. 1945), 152 F. 2d 936, 34 AFTR 651.

payer to obtain the benefit of this subsection though actual tax payment may not have occurred within his tax year.[4] An *exception* to the foregoing method of proration is that it shall *not* apply where *either* the seller or the purchaser computes his taxable income under the *accrual method* of accounting—but does not accrue *real property taxes ratably*. However, provision is made[5] whereby such accrual basis taxpayer may elect, in his first taxable year beginning after December 31, 1953, to ratably accrue over the period in which are incurred the real property taxes. The election is to be made with the filing of the return for the year of the transaction. Under these circumstances, both the buyer and seller may benefit by knowing the method of accounting of the other and whether or not *either* has made an election under this section.

The cost of acquiring a lease may be deductible by the lessee over the term of the lease if the lease is of property used in a trade or business.[6] Thus, if $10,000 is paid to acquire a ten-year lease, then, in addition to annual rent to be paid, $1,000 is also deductible annually without taking into account any right of renewal. The purchaser of property upon which an advantageous long-term lease now exists must take cautious steps. It is essential that the investment in the property on the one hand, and in the leasehold on the other, be separately and clearly stated. Where a taxpayer acquires title to property subject to an outstanding lease, no segregation having been made as to values, depreciation deduction for amortization of the leasehold is disallowed.[7]

A harsh result to the purchaser of real property was reached in the *Hyde Park Realty, Inc.* decision.[8] The sales contract specified a price adjustment, represented by prepaid rents received by the seller, to the extent that such rents covered periods *after* the passage of title. The purchaser had claimed the amount of such rents was in effect a reduction in the cost of acquisition, but the Tax Court held the sum of $8,725.00 was rent taxable to the buyer as ordinary income. The effect was that the buyer "received" ordinary income in the form of advance rentals apportioned to him. The decision appears to turn upon the Court's interpretation of the *intent* of the parties. Apparently, such intent in the instrument was not clearly expressed to the advantage of the buyer.

In *Martha R. Peters*[9] the taxpayer acquired, in a liquidating dividend in kind, an interest in real property under lease, the prior fee owner having no capital investment in the lease. The leasehold, not being acquired as a separate exhaustible asset, is not amortizable over its term. The acquisition of the lease was incident to the real property acquired and is not a wasting asset. In *Milton H. Friend, Trustee*[10] the Board held that the fee interest acquired was not divisible. The case involved an estate's right to amortize the deduction and the Seventh Circuit Court of Appeals[11] affirmed the Board, but upon the theory that the leasehold cost the decedent nothing; and, because he had no right to deduction in his lifetime—he transferred none.

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[4] 1954 IRC 164(d); 1939 IRC 23(c)(1).

[5] 1954 IRC 461(c); 1939 IRC 43.

[6] Reg. 118 Sec. 39.23(a)-10. Similar to 1954 IRC Sec. 162.

[7] *Annex Corp.*, Par. 43,256 Prentice-Hall Memorandum T.C. (1943).

[8] *Hyde Park Realty, Inc.*, 20 T.C. 43 (1953) affirmed (2 Cir. 1954) 211 F. 2d 462.

[9] 4 T.C. 1236 (1945).

[10] 40 B.T.A. 768 (1939).

[11] (7 Cir. 1941) 119 F. 2d 959, 27 AFTR 243.

Consider methods of avoiding such results. For example, the leasehold might be purchased by one person, and the fee title by another; or the leasehold might be acquired prior to purchase of the fee title.[12]

In considering a long-term lease, tax benefits may result from deductions resulting from the agreement to replace property losses from any cause and to return the property in as good condition as when received.[13] The lessor thus loses his right to the deduction for depreciation because he has shifted this burden to the lessee by contract, that is, a contract to make expenditures which *replace* depreciation and to return the property in the same condition and value as when it was leased. In other words, the "allowance" for depreciation to the property owner ceases while the tenant claims its counterpart in replacement costs.[14]

3. How to Make a Lump Sum Purchase of Assets and Avoid Goodwill

Most important in your consideration of the purchaser's problem is the allocation of the total purchase price, that is, the "price tag" to be placed on each individual asset. Where property is acquired as a whole for a lump sum there must be an allocation of the cost or other basis of the several parts so that any gain or loss will be computed upon the disposition of each part.[15]

In several instances, the government has alleged that goodwill (that elusive asset) was among the assets acquired—a very troublesome presumption for the buyer to overcome, and often resulting in litigation. Proper allocation of values in lump sum purchases is *especially* vital to the buyer's tax benefits. He will want a higher basis for inventory and for depreciable properties and should resist as far as possible the attribution of any amount to goodwill. This is so because, taxwise, goodwill is a "dead duck" in his hands—it may not be written off by way of a deduction from income in any form, and loss may be established *only* upon a later sale of the *entire* business or entity. The best evidence the buyer may present to support his allocation is that it was agreed to between the parties in the contract effecting the sale. Ordinarily, this allocation will be accepted in the absence of totally unrealistic values not justified by appraisal or other evidence of actual values. Looking for a moment to the tax standpoint of the seller, his desirable allocation is usually one which will ascribe the gains, if any, to capital assets, and the losses, if any, to non-capital assets. Of course, he is not entirely free to reach this result when conflict arises with the buyer's tax position. In some instances, their tax positions have been resolved by the enactment of Section 117(j) of the 1939 Internal Revenue Code,[16] which, in effect, provides that net gains from the sale of property used in a trade or business subject to depreciation, and held for more than six months, shall be treated as long-term gain from a capital asset, whereas net losses shall be treated as an ordinary deduction. In instances of a business having a substantial proportion of depreciable properties, this treatment means that allocation of a greater part of the consideration to this type of assets may have beneficial results to *both* buyer and seller. One might assume the influence this had on a recent transaction reported briefly as follows:

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[12] See *Cleveland Allerton Hotel, Inc.* v. *Commissioner* (6 Cir. 1948), 166 F. 2d 805, 36 AFTR 862 holding that since the value of the land was concededly only $200,000, the excess paid was necessarily allocable to the lease.

[13] *Commissioner* v. *Terre Haute Electric Co.* (7 Cir. 1934), 67 F. 2d 697 14 AFTR 374; A. Wilhelm Co. 6 B.T.A. 1 (1927).

[14] But the non-existence of this contractual obligation operated to deny the tenant's deduction in *Hotel Kingkade,* 12 T.C. 561 (1949).

[15] *Nathan Blum,* 5 T.C. 709 (1945); *L. M. Graves,* Par. 52,143 Prentice-Hall Memorandum T.C. (1952); *Winifrede Land Co.,* Par. 53,088 Prentice-Hall Memorandum T.C. (1953); *Oliver Iron Mining Co.,* 13 T.C. 416 (1949).

[16] 1954 IRC Sec. 1231.

> Westinghouse Air Brake Co. purchased assets at a cost of $26,000,000.00 from Le Torneau Co. (manufacturers of heavy earth-moving equipment), this being considerably more than the latter's book value. The allocation was $19.5 million to depreciable properties—$6.5 million to inventories. It is believed that the buyer will recover more than half its cost through depreciation deductions over the next ten years. If successful, this amounts to "charging off" the purchase of a business!

That goodwill is a capital asset and is not depreciable seems to be well-recognized —no doubt from the fact that its status as such has never been challenged by the Commissioner. In *Ensley Bank & Trust Co.* v. *United States*,[17] the Court said by way of dictum: "We are of the opinion that there was a sale of goodwill, . . . It is true that it was a capital asset, . . ." It thus follows that the I.R.S.[18] *may* resist allocation to goodwill in computing the seller's profit, though frequently challenging the buyer's depreciation in that a substantial portion of the purchase price was for goodwill. Note that inconsistent treatment of the deal on tax returns of the buyer and seller will certainly arouse the curiosity of the Bureau examiners.[19]

A decision which illustrates unusually well the exercise of care in investigation, planning, and allocating, is the case of *American Fork and Hoe Co.*[20] There the petitioner sustained his burden of proof that no goodwill existed, and further, that proper allocation of values to property subject either to depreciation or amortization was made. Briefly, the facts are as follows: American acquired all the assets of Kelly Axe and Tool Co., paying approximately $5,000,000 by the issuance of stock of American. There was no "reorganization" problem involved. The issue was considered on the premise that the basis of property was cost; and cost was, of course, what the petitioner paid. The problem was to determine *how much* was paid for the *depreciable assets*. The Commissioner had alleged that more than $1,000,000 of the consideration should be assigned to *goodwill and trademarks*, thereby contesting the taxpayer's allocation of the purchase price. The issue, framed at its narrowest point, may be stated: Was *any* amount paid for goodwill? Here, the purchaser had carefully investigated and appraised the plant and believed it worth more than the sum given in allocation and the officers of *both* companies testified that in the negotiations no consideration was given to paying anything for goodwill.

In sustaining the taxpayer, the Tax Court reached its answer by reference to the

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[17] (5 Cir. 1946) 154 F. 2d 968, 34 AFTR 1164. See also, *Aaron Michaels* (footnote 49); from the opinion, "We entertain no doubt that good will and such related items as customers' lists are capital assets."

[18] Internal Revenue Service, formerly Bureau of Internal Revenue.

[19] *Violet Newton*, 12 T.C. 204 (1949). *Giulio Particelli*, see footnote 36.

[20] Par. 43,431 Prentice-Hall Memorandum T.C. (1943).

Republic Steel Corporation case,[21] in which the Court of Claims stated, "The only intangible assets regarded by the parties as of any value were the patents, so it must follow that this sum was paid for the patents. It may be that the seller's goodwill really did have a value, *but if the parties did not think so,* and in computing the price to be paid *gave it no value,* it must be eliminated from consideration in computing the amounts paid for the other assets." (Emphasis supplied.) The *American Fork and Hoe* case affords an excellent example of the precautions taken by the purchaser and emphasizes the sound principle that the parties should agree in the *first instance on an allocation of values.*

A recent example of how goodwill was excluded from the purchase price of a business is to be found in *Seaton Publishing Company.*[22] Again the Commissioner alleged that goodwill was to be included—notwithstanding its omission in the list of property items contained in the agreement of purchase and sale. The Court's opinion stated:

> Respondent's action cannot be approved. We have here what we consider to be a valid and bona fide agreement of sale between the partnership and petitioner covering specified asset items with the total purchase price allocated among the various items . . . No doubt the newspaper business which was involved had a valuable good will. It is apparent to us, however, that good will was not dealt with in the agreement and was not sold under the agreement.

For a case showing the results from omission of allocations in the purchase price, and tax penalty to the buyer, see *Louis Cohen* v. *Kelm.*[23]

4. How to Purchase an Entire Incorporated Business

This problem, common to any prospective purchaser of an incorporated business, is usually an involved one. Here, a separate entity is to be considered. Before any negotiations begin, the buyer should consider and understand the methods of purchase available to him; that the business may be acquired by either buying assets directly, or buying stock from the shareholders. If the latter, he may either hold the stock, keeping the entity intact, or dissolve the corporation to obtain the assets. The method preferred by the purchaser may face resistance from the tax position of the seller. The purchaser would prudently first learn the wishes of the seller.

Of all your considerations of the purchaser's problem, none are more important than the thoroughness of his investigation of the assets desired. It will begin with a determination of the *basis* of the assets in the seller's hands, comparing this with the basis he may expect to achieve from a reasonable allocation of the purchase price. We will assume that the tentative purchase price exceeds the corporation's basis of the assets. This indicates that the better method is to acquire the assets directly from the corporation. However, should the basis of the assets in the hands of the corporation be *greater* than the presently considered purchase price, consideration should be given to acquiring the capital stock from the shareholders, thus preserving the corporate entity for the opportunity of tax savings and quicker recovery of capital through higher deductions for cost of sales, depreciation, etc. The investigation should ascertain the tax benefits now enjoyed by the going concern; that is, accounting methods in use; methods of valuing inventories; methods of computing depreciation, depletion, or amortization; availability of carry-back or carry-forward of any unused net operating loss deductions; and carry-forward of capital losses. All of these factors should be compared with the choice of several accounting procedures which the purchaser may elect in starting a new business of his own with the assets sought to be acquired.

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[21] 40 F. Supp. 1017 (1941), 28 AFTR 175.

[22] Par. 54,104 Prentice-Hall Memorandum T.C. (1954).

[23] 119 F. Supp. 376, (D.C. Minn.)

The proposition that assets may be valued at the entire amount paid for capital stock and thus acquire a basis for gain or loss, depreciation, etc., equal to the purchase price, has been successfully tested.[24]

In substance, these authorities hold that the purchase of the capital stock, and the subsequent liquidation of the corporation, are to be considered as a *single* transaction—because the *sole* intent of the purchaser was to acquire *the assets*. Prior decisions referred to, whether the purchaser be a corporation or an individual, were decided before Section 112(b)(6) of the 1939 Internal Revenue Code had been enacted. This section, in essence, permits a parent to liquidate its wholly owned subsidiary corporation without the recognition of either gain or loss upon the dissolution. The "one-transaction" principle has been extended to include a situation involving the liquidation of a *controlled subsidiary* in the case of *Kimbell-Diamond Milling Co.* v. *Commissioner*.[25] This decision circumvented the nonrecognition Section 112(b)(6) and its corresponding *basis* Section 113(a)(15), holding that the basis to the parent of the liquidated assets *was not* the subsidiary's basis—but the *cost* of the stock to the parent. In *Kimbell* the taxpayer used the proceeds of insurance on its plant destroyed by fire, with additional cash, to purchase the stock of another company whose facilities and equipment were comparable to those which had been destroyed. The other corporation was liquidated within a week after the stock purchase, in accordance with the instructions given by taxpayer's board of directors. Its sole intention in purchasing the capital stock of Whaley Mill and Elevator Company was to acquire those assets and to dissolve the company as soon as practicable. The Tax Court refused to consider this a reorganization within the meaning of Section 112(b)(6), governing its decision by the principles laid down in *Commissioner* v. *Ashland Oil and Refining Co.*,[26] noting in its opinion, "It is well settled that the incidents of taxation depends upon the substance of a transaction."

Several recent decisions by the Tax Court have cited the *Kimbell* case,[27] the principle of which is now enacted in Section 334(b)(2)(B), Internal Revenue Code of 1954.

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[24] *Koppers Coal Co.*, 6 T.C. 1209 (1946) and authorities there cited.

[25] *Kimbell-Diamond Milling Co.*, 14 T.C. 74 (1950), affirmed *per curiam* (5 Cir. 1951) 187 F. 2d 718, 40 AFTR 328, Cert. den. 342 U.S. 827.

[26] *Commissioner* v. *Ashland Oil & Refining* Co. (6 Cir. 1938) 99 F. 2d 588, 21 AFTR 1168, Cert. den. 306 U.S. 661.

[27] *Texas Bank and Trust Company of Dallas*, par. 53,185, Prentice-Hall Memorandum T.C. (1953); *Ruth M. Cullen*, 14 T.C. 368 (1950) Wage, Inc. 19 T.C. 14, (1952); *Pressed Steel Car. Co.*, 20 T.C. 200 (1953); *Austin Transit, Inc.*, 20 T.C. 849 (1953); *H. B. Snively*, 19 T.C. No. 102 (1953); *Kanawha Gas & Utilities Co.*, 19 T.C. No. 1017 (1953), Reversed 5 Cir. 1954, 214 F. 2d 685.

Whenever the buyer is *forced* to purchase the stock in order to obtain the assets, he will be well advised to obtain from the sellers, complete and adequate indemnification covering not only *prior* corporate liabilities not then disclosed, but also any corporate *tax* liability which *may result* from the sale itself. Obviously, without this warranty the buyer has a very justifiable objection to the purchase of stock, for it is *he* who would assume transferee liability, as transferee of the corporate assets. Where an immediate dissolution is planned, careful consideration should be given to all tax benefits accruing to the corporation before its liquidation—such as deductions which it alone may claim and must be paid by it. Usually, in this type of transaction a portion of the consideration is held in escrow and remitted to the seller only after all conditions are satisfactorily met.

The problem of whether the corporation or the shareholders effected the sale of property in connection with a liquidation has been one of considerable controversy and resulting litigation. Consequently, many shareholders have considered the sale of stock as the only means affording sound tax protection, and avoidance of possible double taxation. The Internal Revenue Code of 1954[28] has provided a definite rule intended to resolve this dispute of the past, by permitting the imposition of a single tax at the shareholder level (no gain or loss recognized to the corporation) on property sold during the 12 months' period following a plan of liquidation, irrespective of whether the corporation or the shareholders effected the sale. Certain conditions are to be met in the application of this Section, but should generally enable a purchaser to avoid the necessary acquisition of capital stock (and liquidation) and instead permit him to buy the property desired from the shareholders.

In view of the exhaustive treatment given elsewhere in this book to the purchase and sale of capital stock, and the liquidation of corporations, we turn to the questions incident to acquiring an unincorporated business.

5. How to Purchase an Unincorporated Business

a. A proprietorship. For a time, it was generally believed that when an individual disposed of his business, lock, stock, and barrel, he had sold a single piece of property for tax purposes. This was the finding in *Arkay Drug Co.*[29] Now, however, this view is obsolete. The decision *Williams* v. *McGowan*[30] was that the sale of a sole proprietorship as a going concern was *not* the sale of *one* capital asset. The subject of the sale was, as the contract stated, "All of the right, title and interest in and to the hardware business." The opinion further held that the business was to be "comminuted," and the resulting fragments were to be *separately* matched against the definition of a capital asset. Unless the assets "matched," *ordinary* gain or loss resulted. The court noted that no part of the purchase price was allocated to goodwill, adding the *unique* observation that even if it were, goodwill was a "depreciable intangible." The Tax Court maintains the contrary view, that goodwill is a capital asset not subject to depreciation.[31] You may consider the *Wil-*

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[28] Sec. 337(a),(b)(c).

[29] Par. 44,364 Prentice-Hall Memorandum T.C. (1944).

[30] (2 Cir. 1945) 152 F. 2d 570, 34 AFTR 615. See also Rev. Rul. 55-79, I.R.B. 1955-7, 18.

[31] *Estate of John C. Burns,* Par. 47,242 Prentice-Hall Memorandum T.C. (1947).

liams[32] case as leading authority for the tax aspects incident to the transfer of a proprietorship business, though opposed to the very clear and persuasive logic of Judge Frank's dissenting opinion. He would have classified the business as a separate "entity" (from the terms of the contract).

Two cases before the Tax Court have since been decided, *Estate of John C. Burns,*[33] and *Violet Newton,* supra,[34] involving sellers of a proprietorship business for a lump sum. Both illustrate how costly the failure to arrive at an agreed allocation can be. In each instance, the taxpayer (the seller) attempted to increase the gain realized upon the sale of his goodwill (a capital asset) and to reduce correspondingly the gain attributable to assets from which an ordinary profit would result, neither party having determined beforehand the value of goodwill. Their meager proof could not overcome the presumption of correctness which adheres to the Commissioner's determination. The failure to show that a definite portion of the gain was from the sale of goodwill was particularly evident in the *Newton* case. The assets sold were an inventory of merchandise, accounts receivable, credit deposit, *and goodwill.* But there was no breakdown or allocation of the selling price with respect to tangible and intangible property. The taxpayer had treated the entire gain from the sale as "capital" gain, while the Commissioner determined that 95 per cent was ordinary income with 5 per cent as capital gain. The inventory was the principal asset sold (determined by the Commissioner as 95 per cent of the total) thus, the gain was alleged to be ordinary income since there was no evidence in the record upon which the Court could base an allocation of the purchase price to goodwill. While these cases involved the seller's problem, they offer valuable guidance to the purchaser in arranging his affairs.

In acquiring a sole proprietorship, the purchaser and seller are likely to have contrasting tax objectives, perhaps to a greater extent than in any other transaction for business property. (See the remarks pertinent hereto in Section 3.) The best advice to a purchaser is that he should reach an agreement with the seller in placing a value on *each* individual asset contained in the business. He will urge and insist upon valuing assets in this order (from highest to lowest): inventories, machinery and equipment, leasehold improvements, other depreciable property, and lastly, goodwill.[35] Where arbitrary allocations are made following a lump sum purchase, it is invariably contested by the government. Moral: Don't leave yourself to the mercy of the I.R.S. allocations. This controversy can be avoided if the parties will agree on values of the elements of the business—it is advisable to give and take a little. This is the soundest principle. Allocations agreed upon are entitled to respect, but will gain approval only if a realistic view shows the transaction was reached at arm's length—both as to total purchase price *and* division between capital and non-capital assets.[36]

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[32] Approval of this case is indicated by the Supreme Court in *Ernest A. Watson and Gladys Watson* v. *Commissioner*, 345 U.S. 544, 73 S. Ct. 848, 43 AFTR 621 (1953).

[33] Footnote 31 above.

[34] Footnote 19 above.

[35] But the seller's opposition may stem from the harsh results in *Grace Bros., Inc.*, 10 T.C. 158 (1948), affirmed (9 Cir. 1949) 173 F. 2d 170, 37 AFTR 1006, where all gain from the sale of a winery was attributable to the inventory and none to goodwill—illustrating perfectly the need for clear identification of goodwill, if there be any. See also *Harlan E. McGregor*, T.C. Memo, 1954-56.

[36] See *Giulio Particelli*, Par. 52,044, Prentice-Hall Memorandum Decision T.C. (1952), affirmed (9 Cir. 1954) 212 F. 2d 498.

A contractual agreement may be disregarded for tax purposes where it fails to reflect the true factual situation.[37] A retiring partner, at the time of withdrawal from the firm, accepted an offer of $72,000.00 for his interest, as reflected in an agreement whereby he would be paid $2,000.00 per month for a period of three years. The language of the agreement appeared to resemble an *employment contract,* thus permitting the partnership to deduct the amount as compensation with its consequent tax benefit to the partners. The monthly payments claimed as compensation were held by the Tax Court as properly disallowed by the Commissioner where the facts disclosed the payments were actually made to acquire the retiring partner's interest in the firm. Inaccurate tax counsel was given the buyer that he could "charge off" the purchase price in this manner. The Court rejected the contract as failing properly to describe the transaction, held that the payments were to acquire the interest of the partner—none of which was for services rendered or *to be rendered.* Ordinarily, the Courts won't upset a contract if it *approximates* the actual deal contemplated. The safest procedure is to *know* your tax consequences before you negotiate the contract.

The following table[38] summarizes the valuations buyers should strive for in distributing purchase price for assets in bulk purchases:

Asset	*Value*	*Explanation*
Merchandise inventory, stock in trade	High	A high cost will reduce your operating profit, because your cost would be fully deductible.
Supplies and similar items not used in the manufacture of the product	High	These supplies will be used as expense items in the ordinary course of the business—your cost is fully deductible, as above.
Accounts receivable	High	Same as the first item, above. Loss from bad debts would be business bad debts and fully deductible.
Machinery, equipment of short life	High	You get deductible depreciation to recover the cost. Loss on sale or abandonment is fully deductible.
Buildings, building improvements; machinery, equipment of long life	Low, if necessary.	You get deductible depreciation to recover cost. Loss on sale or abandonment is fully deductible.
Land	Low	No depreciation is allowed. Any gain would be a capital gain.
Stocks, bonds and securities	Low	Gain would be taxed at capital gain rates.
Patents, copyrights, franchise, etc., amortizable intangibles	High only if remaining life is short	You get a deduction if remaining life is short. But value these at low figures if you propose to sell the asset quickly, and you need to increase value of

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[37] *Estate of Geo. A. McDevitt,* Par. 53,032, Prentice-Hall Memorandum T.C. (1953). See also, A. *Rhett DuPont,* 19 T.C. 377 (1952), N. *Paul Kenworthy,* Par. 52,013 Prentice-Hall Memorandum T.C. (1952) affirmed per curiam 197 F. 2d 525 (3 Cir. 1952), 42 AFTR 46.

[38] Adapted from J. K. Lasser, *Business Tax Handbook.* New York: Simon and Schuster, 1950.

Asset	*Value*	*Explanation*
		other assets. Gain on sale is capital gain.
Goodwill	Low, if necessary	The cost is recovered only through eventual sale of the business. But place some value on goodwill in order to have a cost basis. Any profits in a sale would be capital gains.
Covenant of the seller not to compete with you	High	The payment is fully deductible over the period of the covenant. This covenant must be carefully defined in the contract or else the sum for it may be held to be payment for goodwill.

b. Partnerships. The problems normally present in the purchase of assets of a partnership business should not differ from those discussed above pertaining to a proprietorship. The decision to buy the assets or to buy the individual partner's interests must proceed from a thorough investigation of the *basis* of the assets in the firm. You should advise the purchaser that, generally, the safest course to pursue is the purchase of the *assets* of the business, the result being similar to that found in *Williams* v. *McGowan.*[39] The more favorable tax treatment now accorded gains or losses from the sale of business assets *subject to depreciation*[40] will tend to harmonize tax objectives of buyer and seller.

The acquisition of the assets may be accomplished either by a purchase directly from the partnership business (now accorded the status of a separate entity) or the assets may be purchased from the partners (or a partner). In the latter instance, there would first occur a distribution in kind to the partners of the assets to be sold, and they would effect the sale. The purchase of a partnership *interest* is buying into a business, and this method is usually employed only where one wishes to acquire the proprietary interest of another individual in a going business entity.

From the seller's standpoint, there is adequate authority holding that an interest in a partnership may be sold as a capital asset—that such an interest is to be considered apart from the assets in the partnership which underlie the interest. The decisions on this point by the Tax Court in both reported and memorandum form are legion.[41] Affirmances from the second, third, fifth, sixth, and ninth Circuit Courts of Appeal hold that such an interest is a capital asset.[42] The Commissioner acquiesced by issuance of his ruling, but excepting this application to cases where earnings for past services are involved.[43]

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[39] Footnote 30 above.

[40] See footnote 16.

[41] *Dudley T. Humphrey*, 32 B.T.A. 280 (1935) (non-acq.); *Frank B. Killian*, T.C. Memo. (1944), Prentice-Hall Memorandum T.C., par. 44,244; *L. F. Long*, T.C. Memo. (1947) Prentice-Hall Memorandum T.C., par. 47,155; *R. S. LeSage*, T.C. Memo. (1947), Prentice-Hall Memorandum T.C., par. 47,318; *H. R. Smith*, 10 T.C. 398 (1948) affirmed, see footnote 42; *Estate of Aaron Lowenstein*, 12 T.C. 90 (1949).

[42] *Commissioner* v. *Lehman* (2 Cir. 1948), 165 F. 2d 383, 36 AFTR 545; *Thornley* v. *Commissioner* (3 Cir. 1944), 147 F. 2d 416, 33 AFTR 684; *Commissioner* v. *Smith* (5 Cir. 1949), 173 F. 2d 473, 32 AFTR 430; *Commissioner* v. *Shapiro* (6 Cir. 1942), 125 F. 2d 532, 24 AFTR 9; *Stilgenbauer* (9 Cir. 1940), 115 F. 2d 283, 25 AFTR 966; *Estate of Daniel Gartling* (9 Cir. 1948), 170 F. 2d 73, 37 AFTR 322.

Where one partner acquires the interests of *all* the other partners, he becomes the sole owner and the business will be treated as a proprietorship.[44] But note that the *basis* of the assets (of the former partnership) is affected, and a *new basis* results to the purchaser. In the cited case, a partner purchased the interest of his only other partner and continued the business—the consideration being an amount *less* than the selling partner's capital account. The Commissioner attempted to assess this "bargain purchase" as income, but the Tax Court turned him down, holding that the net effect of the transaction was a *reduced* cost of the partnership assets acquired and additional income will be realized *only* when such assets are disposed of. What the taxpayer bought was a new interest in—and a new cost basis for—the partnership assets, and this must be allocated *proportionately* to the separate assets in the ratio of cost to book value.

The Internal Revenue Code of 1954 has made broad and extensive changes in the field of partnerships. Many of these are highly complex, which the very nature of the partnership relationship makes inevitable. This is particularly true in *basis* problems—of the partnership interest, of property distributed by, or contributed to a partnership. In the transfer of partnership property, more intricate tax problems confront the seller than the buyer. These are comprehensively explained in another chapter of this book—Selling Partnership Interests and Partnership Property.

6. How to Use Covenants Not to Compete

This chapter attempts to show how the buyer may secure ordinary deductions for his purchase price, and to observe some of the obstacles usually found in his path. The ideal result is never a simple matter to accomplish. The periodic write-off of lump sums paid to refrain from competition with the purchaser for a specified period, has come in for a full share of controversy and litigation with the Commissioner, with both buyer and seller as litigants. This was the situation before the Tax Court in *Toledo Newspaper Co.*[45] and the *Toledo Blade Co.*[46] cases. The vendor and vendee having taken opposing positions, it follows that the Commissioner would likewise take conflicting views. But one consistency seems certain in this tax equation; if the promisee gets an ordinary deduction for his payment, it will result in ordinary income to the promisor.

Where the vendor of a business covenants to refrain for a specified period from competing with the vendee, there will arise questions of paramount concern to both parties with respect to the status, for tax purposes, of the consideration paid for the covenant. Of obvious tax significance to the seller is the answer to the question of whether the payment received represents capital gain from the sale of an asset (goodwill), or ordinary income. Of equal importance to the buyer are the answers to these questions: does the price paid for the agreement not to compete represent a business expense, or the purchase of an asset; and if an asset has been purchased, is depreciation thereon allowable? Of vital concern to the buyer is whether the consideration paid for the covenant is *separable* from that paid for other assets of the business, i.e., goodwill.

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[43] G.C.M. 26379, 1950-1 C.B. 58.

[44] *Helen Davis,* Par. 50,074 Prentice-Hall Memorandum T.C. (1950).

[45] 2 T.C. 794 (1943) (acq.).

[46] 11 T.C. 1079 (1948). Affirmed (6 Cir. 1950) 180 F. 2d 357, 39 AFTR 7.

From the seller's standpoint, the proposition appears to be that if the covenant is executed coincident with and as part of the contract of sale, the covenant is a capital asset transaction and the amount received does not represent ordinary income. The purchaser's position will follow from this—that he has acquired an asset (such things as goodwill, customers list, etc.) which may *not* be written off against his business income. No deduction for depreciation is allowable with respect to goodwill.[47] Similarly, it has been held that a newspaper subscription list, since it has no definite life, is not subject to depreciation allowances.[48]

In other words, the entire consideration received in the sale may be treated as a whole, and therefore indivisible, where forbearance from competition is a concomitant of the sale of the goodwill itself, and the cost of the agreement cannot be amortized, the result in *Toledo Newspaper Co.*, supra, and in *Aaron Michaels*.[49] The problem resolves itself into the question of whether or not the "covenant" is actually a protection, or assurance of the beneficial enjoyment of goodwill.[50] Upon the purchaser falls the task of showing that the covenant is *not* in effect the purchase of goodwill, but of some other asset of the business. This is frequently difficult. The cases here cited illustrate that goodwill was by no means the principal asset acquired, and that the elimination of competition was a compelling motive of the purchase.[51]

In the *Michaels* case, the seller was before the Tax Court in a determination of the *type* of income received from the sale of his proprietorship business with an agreement not to engage in a similar business for five years. The Court found as a fact that "Goodwill and the customers list were substantially the same. The agreement not to compete was an integral part of the customers list and goodwill." The opinion stated:

> If such an agreement can be segregated, not so much for purposes of valuation, as in order to be assured that a separate item has actually been dealt with, the agreement is ordinary income and not the sale of a capital asset. But where it accompanies the transfer of good will in the sale of a going business and it is apparent that the covenant not to compete has the function primarily of assuring to the purchaser the beneficial enjoyment of the good will which he has acquired, the covenant is regarded as nonseverable and as being in effect a contributing element to the assets transferred.

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[47] Reg. 118 Sec. 29.23(1)-3. See *Los Angeles Towel Service Company*, Par. 49,228 Prentice-Hall Memorandum T.C. (1949) wherein taxpayer attempted to deduct as a business expense "commissions" paid incident to the acquisition which the Court held to be part of the purchase price and not subject to amortization. See also, *Anchor Cleaning Service, Inc.*, 22 T.C. No. 124 (1954).

[48] *Danville Press, Inc.*, 1 B.T.A. 1171 (1925).

[49] 12 T.C. 17 (1949) (acq.).

[50] See the decision in *Lloyd H. Walker and Gretchen C. Walker*, T.C. Memo. 1954-56. The function of the agreement was, the Court said,

> That the covenant not to compete was inserted in the sales contract, not as a separate item, but rather to protect these intangible assets appears from the testimony of the petitioner's own opinion witness.

See also *D. & H. Bagel Bakery, Inc.*, T.C. Memo. 1954-56.

[51] *Wilson Athletic Goods Mfg. Co., Inc.* v. *Commissioner* (7 Cir. 1955) 222 F. 2d 355, reversing T.C. Memo. 1954-56; *Carl Dauksch* v. *Busey*, 125 F. Supp. 130 (D.C. Ohio), 1954.

But the opinion also left this for consideration:

> We have accordingly found as a fact, *though the matter is not free from doubt,* that the agreement to refrain from competition should be treated as a capital asset ancillary to the transfer of good will and customers. (Emphasis supplied.)

The facts surrounding the contractual agreement between the Toledo Newspaper Co.[52] (the seller) and the Toledo Blade Co. (the purchaser) are interesting enough to relate briefly. The consideration of $880,000 paid in 1938 was divided between $100,000 for purchase of the name, subscription lists, etc., and $780,000 for *discontinuing* publication and *refraining* from competition for ten years. The contract further provided that the two companies would share equally in any tax savings that might result in the Blade Co. from deductions taken on account of the $780,000 payment. Toledo Newspaper Co. sought to prove that the basis (March 1, 1913 value) was *more* than the consideration and therefore *it had no income,* with the Commissioner proposing to tax $780,000 in the covenant not to compete as ordinary income. Neither prevailed. It was held that the entire consideration, less adjusted basis for certain intangible assets, was the sale of goodwill, subscription lists, etc., and thus were capital assets.

The *Toledo Blade Co.* case before the Tax Court sought (in one of two issues present) to sustain its deduction for amortization of the restrictive covenant in the contract at the alleged cost of $780,000. The Commissioner contended, however, that goodwill was acquired in a single transaction for the lump sum of $880,000, and therefore the petitioner acquired *no property subject* to amortization or depreciation. On this point he succeeded, since the Court reached that conclusion in the earlier *Toledo Newspaper Co.* case as to the nature of the contract, that is, it was *not* divisible, and the total consideration of $880,000 was the price paid for the going business and intangible assets, "including goodwill and the covenant not to compete." The Court simply found no evidence that any asset acquired under the contract had a definite cost recoverable through amortization deductions. Four judges registered a strong dissent upon logic which seems inescapable, concluding their opinion with this terse remark, "The one sure way to do injustice in such cases is to allow nothing whatever upon the excuse that we cannot tell how much to allow."

An observation of the unfortunate results in these situations is that the covenant was an "integral part" of the intangible assets sold and thus forbearance from competition was intrinsic in the sale of goodwill. The purchaser should direct his attention to the separability of the covenant and goodwill, to show that *the former is in fact* something other than goodwill.

A more recent controversy, again involving the purchase and sale of a newspaper, affords little aid in solving this two-sided muddle. In the *Gazette Telegraph Company* case[53] all of its stock (a newspaper publisher) was purchased in a contract of sale wherein the value of each share of stock was stipulated to be $150.00, and the covenant not to compete on the part of each of the stockholders (which was specifically made assignable) was valued at $50.00 per share—total price of the stock being fixed at $750,000.00 and that of the covenant at $250,000.00. At the insistence of the buyer, the consideration for the covenant was stated separately, his purpose being to establish its value for amortization, and also for liquidated damages in the event of its breach. The Commissioner contended that the covenant must be regarded as *non-severable* from goodwill—hence was not subject to amortization—but the Court decided against him, finding that the parties had dealt with one another at arm's length, that the covenant was treated by them as a *separate item,* and in a separable manner as to value. In a companion case decided the same day, the sellers (owners of the entire capital stock)[54] had reported the gain on their tax returns as a capital transaction, showing their entire gain as long-term capital gain, contending that the money they received was *all* received for their stock, but the Court held against them on the premise that the covenant *was* a separate item of the transaction and any other construction would make meaningless the allocation clause of the contract. Judges Johnson and Turner registered their dissents in both decisions observing in the *Hamlin Trust* case that the sellers were *unaware* of the tax consequences to them. Both litigants appealed their cases to the Tenth Circuit Court of Appeals, the Commissioner in the *Gazette Telegraph* case and the sellers of the stock in the *Hamlin Trust* case, the Circuit Court affirming in both cases. The condition existing in these cases illustrates the fact that sometimes the Commissioner will balk at accepting the contract's allocation when it comes to the party who *benefits,* but, as shown in the *Hamlin Trust* decision, will argue that the party who is placed at a disadvantage by the contract is *nevertheless* bound by its terms.

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[52] See footnotes 45 and 46.

[53] 19 T.C. 692 (1953), affirmed (10 Cir. 1954) 209 F. 2d 926.

Still another litigation involving the sale of a newspaper business is reported in *George H. Payne and Madeline Payne,*[55] reminding us of the admonition by the Tenth Circuit Court of Appeals in the *Hamlin Trust* case—

> . . . Where parties enter into an agreement, with a clear understanding of its substance and content, they cannot be heard to say later that they overlooked possible tax consequences.

In the *Payne* case, petitioners (husband and wife), and another shareholder, sold all of the capital stock of a newspaper corporation. However, two contracts of sale were introduced in evidence—exactly alike except that one reduced the total consideration for the capital stock by $100,000.00 and allocated that sum to the paragraph containing the covenant not to compete for a ten year period. The parties to the transaction had engaged in considerable controversy as to which document was executed first. The second agreement containing the covenant clause (requested by the purchaser) was never signed by the third stockholder; still the Commissioner determined that $100,000.00 of the total consideration was for the covenant and therefore petitioners should have reported this amount as *ordinary income* rather than as capital gain. But the Court's opinion observed,

> The record clearly demonstrates that the covenant is inextricably linked with the transfer of the corporate good will . . . Any value attributable to the covenant is nonseverable from this good will.

The Court further noted that the covenant was never bargained for, never evaluated and any consideration given it was whether the buyer should be given a tax advantage which might cause a tax result disadvantageous to the sellers. It should be further observed that goodwill, as a separate item, can never be involved where *all* the shareholders sell their stock—the goodwill (if any) *automatically* passes.

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[54] *Clarence Clark Hamlin Trust, et al.,* 19 T.C. 718 (1953), affirmed (10 Cir. 1954) 209 F. 2d 761.

[55] T.C. Memo. 1954-56. See also, *Lee Ruwitch,* 22 T.C. No. 127 (1954).

The separability of the two elements is illustrated in the case of *Rodney B. Horton*[56] where the taxpayer, a certified public accountant, had sold his individual accounting practice. Of payments received, the Tax Court held that 50 per cent was paid in consideration of goodwill taxable as capital gain, and 50 per cent was paid in consideration of the covenant not to compete, taxable as ordinary income. This allocation emphasizes that "the matter is not free from doubt." Therefore, be *specific* in the allocation.

You should consider the use of an escrow agreement with a third party, who will pay the annual or periodic sum to the seller as long as no violation of the non-compete agreement is found, with the further agreement that the *seller recognizes* such sums as *compensation* to him for *not entering a competitive field*. Strictly speaking, it is a promise not to work for others or for oneself, and is not a conveyance of property. A thorough treatise of this subject is to be found in another chapter of this book.

7. How and When to Use Lease Agreements with Option to Purchase

Small businesses and businessmen, lacking funds for development and expansion, and needing a safeguard against an uncertain financial future, will frequently seek ways and means of obtaining the *equivalent* of a deduction of the purchase price, such as is found in a lease with option to purchase. But this device has its attendant risks of not succeeding. In addition, a host of decisions exists on this proposition, pointing out its uncertainties and its inherent gamble on the outcome.[57] More recent decisions are analyzed here. We must concede the increasing difficulty presented, year after year, in attaining success in tax saving schemes. To obtain a rental deduction, the lessee must establish that the property involved is one "to which the taxpayer has not taken or is not taking title or in which he has no equity." [58] The crucible more often lies in the determination of acquiring an

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[56] 13 T.C. 143 (1949) (non-acq.); Commissioner's appeal dismissed, 10 Cir. 1950, 180 F. 2d 354; see also *Richard S. Wyler*, 14 T.C. 1251, 1950 and *Estate of F. G. Masquelette*, T.C. Memo. 1954-56 (sale of accounting practice); *Max Swiren* v. *Commissioner* (7 Cir. 1950), 183 F. 2d 656, 39 AFTR 781 (sale of interest in law firm).

[57] *Edw. E. Haverstick*, 13 B.T.A. 837 (1928), holding that the seller received income *as rent* until option exercised and such payments were not property payments; E. G. *Robertson*, 19 B.T.A. 534 (1930), payments received were held not to be rent income, but income from installment sale; *Alexander W. Smith*, 20 B.T.A. 27 (1930), payments received were not rent; transaction was a conditional sale; *Indian Creek Coal & Coke Co.*, 23 B.T.A. 950 (1931), royalty payments prior to exercise of option served to reduce purchase price and were not again to be added to determine income from sale of property; *Robert A. Taft*, 27 B.T.A. 808 (1933), transaction held to be a sale, not a lease; *Rankin* v. *Commissioner* (6 Cir. 1932) 60 F. 2d 76, 11 AFTR 706. Contract was held to be a purchase rather than a lease, where costly improvements were sought to be exhausted over a short-term "lease"; *Watson* v. *Commissioner* (9 Cir. 1932), 62 F. 2d 35, 11 AFTR 1051, purported lease was held to be a sale, involving large down-payment upon execution, with $1. as final payment; *Rotorite, Inc.* v. *Commissioner* (7 Cir. 1941) 117 F. 2d 245, 26 AFTR 393. Sums paid prior to year of exercise of option are royalty income, though ultimately credited on purchase price; sums paid in year of exercise are "purchase money payments."

[58] 1939 IRC Sec. 23(a)(1)(A), 1954 IRC Sec. 162.

"equity," and also in the *intent* of the parties. Moreover, a grave danger exists in these arrangements in that I.R.S. is not required to treat the transaction consistently for both lessor and lessee, nor do the Courts so interpret statutory provisions. This is true because the buyer's tax deduction is controlled by the language of deduction sections, and there is no reciprocal relationship between these sections and the tax treatment to the seller of the periodic payments received by him.

In spite of the language of the contract—a "lease and option," and "to lease and rent"—consideration was given to all the surrounding circumstances indicating the intent of the parties, and the Court concluded that the transaction was a *sale* on terms of one-half down and the balance in six months, not a lease and subsequent sale. Therefore, no part of the gain was ordinary income but the total gain represented a long-term capital gain.[59] In another decision, the Tax Court considered itself not bound to allow a deduction for rent, merely by a recital in a so-called lease that the payments made thereunder would *not constitute a portion of the purchase price*. It found the *concept* of a sale and purchase pervaded the entire transaction.[60]

Two important decisions by the Tax Court are deserving of mention. In *Judson Mills*,[61] the *lessee-taxpayer* claimed deductions for rents paid under three lease agreements designating monthly payments as "rent" over a period of five years, after which title to the machinery could be acquired by payment of an additional amount. In two agreements the option to purchase had expired, and purchase was effected only by extensions of the exercisable clause. Further, the leases provided that the lessee was responsible for damages, and *if he should be declared insolvent the lessor could repossess the machinery*. The taxpayer's alternative contention was that, if he was not entitled to rent deduction, he was entitled to a deduction for interest paid (interest was not specifically stated in the agreements, but amounts representing both principal and interest were determinable). On this contention the taxpayer prevailed, with two judges dissenting. This view of the interest question served to strengthen the Court's conviction that the machinery *was being acquired*. Judge Disney, in a lengthy opinion, dissented from the holding that the monthly payments were not rent, and stated, *inter alia*, "In my view, the fact that there were options to purchase at the end of the rental period involved, is given inordinate weight. The question is: What was the primary purpose of the agreement?" He believed the payment to be deductible as rent, because the primary purpose of the agreement was rental, not passage of title. Moreover, he said, "a very substantial amount, perhaps all the property was then worth, was to be paid under the option."

The *lessor's* side of a similar situation was shown in *Truman Bowen*,[62] wherein the petitioner contended that the monthly payments did not constitute rent, with the Commissioner asserting they did. (A position exactly contrary to that in *Judson Mills, supra.*) The petitioner argued successfully that the payments made were for property sold. The taxpayer rented machinery to the Federal Government under agreement designating the parties as "lessor" and "lessee" and the monthly payments as "rent." The Government could acquire title automatically when payments equaled the stated values of items in the contract, plus an additional amount equal to 1 per cent per month of such stated values. In a well reasoned discussion, prefaced by the remark, "The determination of the question whether an agreement is a lease or a conditional sales contract is often difficult," the opinion offers citations to practically all leading decisions and draws from authoritative legal textbooks. But a dissenting opinion by Judge Johnson (concurred in by six other judges) has sound logic in its argument that the Government requires no "easy payment plans," and if it had *intended* to purchase the equipment when the contract was made, it would have done so *then* for cash. Because it did not do so, the conclusion is that *it had no intention to buy,* only to rent. The dissent holds the *Bowen* case not distinguishable from *Estate of Clarence B. Eaton*[63] (opinion by Judge Johnson, without dissent), a decision reaching perhaps the most logical result. This case involved the same issue and type of government contract as did *Truman Bowen,* supra. It held that amounts paid for use of the equipment prior to April, 1942 were rentals and taxable to the petitioner as ordinary income, but *subsequent* to this date (when the election to purchase was made), such payments were purchase price and taxable as capital gains.

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[59] *W. Clayton Lemon* v. *U.S.*, 115 F. Supp. 573 (D.C. Va. 1953).

[60] *Marvin Berry*, Par. 52,093, Prentice-Hall Memorandum T.C. (1952).

[61] 11 T.C. 25 (1948) (acq).

[62] 12 T.C. 446 (1949) (acq.) (Commissioner's appeal dismissed).

The Tax Court in *Chicago Stoker Corporation*[64] followed the *Bowen* decision in which it laid down this criteria, or "economic" test:

> If payments are large enough to exceed the depreciation and value of the property, and thus give the payor an equity in the property, it is less of a distortion of income to regard the payments as purchase price and allow depreciation on the property than to offset the entire payment against the income of one year.

The Fifth Circuit Court of Appeals, in *Benton* v. *Commissioner,*[65] has declined to adopt this "economic" test above referred to, and holds that the proper rule is to determine whether that which is *in form a lease* is, in effect, a conditional sale contract. The answer to this question, as the Court states, depends upon the *intention* of the parties, and the economic relation of the value of the property to the option price is only *one factor* to be considered in determining *intent.* Further, this factor should be considered in view of facts and circumstances as they existed at the *time* the contract was entered into, not as of the time for the exercise of the option. Accordingly, the decision held that the parties in good faith actually *intended* to enter into a lease contract, and the taxpayer (until he exercised the option to purchase) acquired no equity in the property.

The recent decision by the Tax Court in *Calcasieu Paper Co., Inc.*[66] should be examined. It illustrates that leases with option to purchase continue to trouble taxpayers, the Treasury, and Courts alike, and the Courts are generally unable to set any *objective standard* by which to judge whether the arrangement is a lease or a sale, for tax purposes. The case involved an aggregate rental of $300,000.00, $30,000.00 annually for a period of ten years, beginning in 1947. The option given the taxpayer-tenant was that it could be exercised *only* after a period of six years from the date of the lease. Beginning in the 7th year (1953) the tenant could buy the plant for $120,000.00, and all rentals paid thereafter would be applied to this price. In other words, if the option was exercised, the last four annual rental payments would constitute the full purchase price. The Tax Court held the 1947 payment *was* deductible as rent—it *was not* a purchase payment because it did not build up any equity in the property. The decision appears to rely principally upon the fact that the property wasn't worth *any more* than $120,000.00; therefore, payments prior to 1953 would not be creating an equity in the property. But an important reasoning must have been the fact that the option *was not exercisable* for the period 1947-53 inclusive, and therefore (apparently), rent paid in *any* of the first six years would have been allowed as rent.

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[63] 10 T.C. 869 (1948).

[64] 14 T.C. 441 (1950).

[65] *H. T. Benton and Elizabeth Benton* v. *Commissioner,* 197 F. 2d 745 (5 Cir. 1952) 42 AFTR 229, reversing Tax Court, par. 50,223, Prentice-Hall Memorandum T.C. (1950).

[66] Par. 53,028, Prentice-Hall Memorandum T.C. (1953).

Under the lease, the tenant was obligated to pay $300,000.00 over the ten-year term which gave him the right to the building; the option was exercisable at any time between April 15, 1953 and April 15, 1955, providing that all amounts paid as rent after the 1953 date could be credited to the purchase price. Obviously, it required no *additional* amount to acquire the property and it is hardly conceivable that the option would not be exercised since the *same payments* were required in any event. The result is not quite as clear as the Court's reasoning suggests. It may be regarded as problematical whether a Court would accept the exact breakdown as shown by the lease in this case, particularly if the rental payments were *excessively* large in the first half of the term and correspondingly small in the last half. Some rent variation from year to year might be recognized as reflecting a deterioration in the value of the property, but a very wide discrepancy could lead to the conclusion that the larger rental payments should be treated as a prepaid expense, amortizable over the life of the lease.

A type of lease to be avoided is that illustrated in the decision of *Helser Machine and Marine Works*,[67] where the lessee, under a ten-year term lease, had the privilege of applying the monthly rental payments toward the purchase price, it being agreed that title would be transferred at the termination of the lease when the total payments aggregated $19,200.00. Here, the lessee could obtain title *at any time* prior to the expiration of the lease by paying the rental for the remaining period. The Board of Tax Appeals (now the Tax Court) had little difficulty in finding that there was a sale, not a lease, and accordingly disallowed deductions represented by the "rental payments." In the *Calcasieu* decision the taxpayer had no right (in the taxable year) to exercise the option to purchase—a very important factor.

In circumstances where the rental payments are sought to be applied against the purchase price on exercise of the option, a very critical date will be determined; that is, the date *after which* payments will no longer be regarded as rent. The desired result, as found in the *Eaton* decision,[68] is to have the payments regarded as *rent* until the option is exercised; thereafter annual payments, or the lump sum balance be regarded as payment of the purchase price.

An analysis of all the decisions, with their varying results, leaves no satisfactory, distinct, or uniform line of reasoning for accurate guidance. These are "fact" cases —and the facts are usually decisive. It does seem abundantly clear, however, that the weaker cases for the purchaser involving the deductibility of payments *as rent* are those in which only a nominal amount is required for the passage of title; and the stronger cases are those in which a substantial sum—bearing a relationship to the true value of the property—is paid when the option is exercised. We must squarely face the fact that taxpayers with leases containing a favorable purchase option *may not* get this benefit. This is particularly true in instances where machinery or equipment is rented for a short period, but with the last rental payment only a nominal sum is required to acquire title.[69]

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[67] 39 B.T.A. 644 (1939).

[68] See footnote 63.

8. When to Consider Deductions for Use of Property, Instead of Purchase

The theory of deductions from income for the *use* of property in preference to a *purchase* thereof has behind it numerous *advantages*, especially significant to those whose incomes reach high surtax brackets, and excess profits tax provisions applicable to corporations. In recent years a very distinct trend by businesses, both large and small, to rent or lease *all* types of properties, is quite evident. The *advantages* are: he avoids a large capital outlay, usually he need not worry about maintenance, but mainly he can deduct his costs of leasing as a business expense. Also, he can be *certain* of his deduction for amortization or write-off of improvements made to leased property (under express terms of the lease) and thus avoid the uncertainty, and the disputes, frequently encountered from depreciation claimed for exhaustible property owned—the life of which is subject to opinion differences. Men in big and expanding business are aware of the inexorable pressures of industrial evolutionary forces bringing about gradual replacement of the old with the new. The factor of obsolescence is ruthless, so, in this era of high income taxes, it frequently appears as a safer gamble to lease property, including *land*—as well as improvements—than to sink large sums in ownership. Sales of property with "lease-back" arrangements has become a by-word in American business.[70] But a "new" look is now being taken of this picture, in view of the more liberal depreciation formulas provided in the 1954 Revenue Code, applicable to tangible property with a useful life of three years or more and acquired after December 31, 1953, with *original* use commencing with the taxpayer.

Deductions from income for the continued use of property, as a business expense, but equivalent to the purchase thereof, are illustrated in three cases below. In *Associated Patentees, Inc.*,[71] the ultimate amount of the purchase price depended upon future events, with advantageous tax treatment to buyer and seller, where four individuals (not professional inventors) transferred patents to the corporation in exchange for its agreement to pay them 80 per cent (20 per cent each) of the annual gross income for licenses granted to use the patent. These amounts were deducted by the taxpayer as royalties. The Court denied this, holding that the payments were a capital expenditure made in acquisition of the patents. *How-*

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[69] *Estate of Clarence B. Eaton*, footnote 63 above. See also *Breece Veneer & Panel Co.*, 22 T.C. No. 172 (1954); *Estate of Jno. P. Abramson* v. *Jack*, D.C. Iowa, 1955; I.R.S. states its position in Rev. Rul. 55-540, 541, 542, I.R.B. No. 35 (p. 9, 6, 14).

[70] See the article by John C. Bruton, "To Own or to Lease Property," 29 *Taxes*, pages 657-661, August 1951.

[71] 4 T.C. 979 (1945) (acq.).

ever, the Court allowed the full amount paid as *equivalent* to an annual depreciation deduction on the theory that since the patents were exhaustible, and the amount of future annual payments *could not be foretold*, no method of depreciating the cost would result in a reasonable allowance for depreciation, except the allowance of the *full* amount of the annual payment. The ingenious conclusion was that an ordinary deduction was allowed the purchaser, while capital gains resulted to the four sellers.

Citing the above case, the Tax Court held, in *M. E. Cunningham Company*,[72] the cost of a machine, expressed in terms of a yearly percentage of income, should be recovered through deductions equal to the amount of the yearly payments. The developer of the machine had transferred it to the taxpayer, which had agreed to pay him 5 per cent of sales of the item manufactured each year (profits permitting), but to accrue no amount if any year failed to show a profit. While the Court regarded the payments as part of the *cost* of the machine, it held that the amounts paid under the agreement in the taxable year were deductible—either as a business expense, or as a depreciation deduction. The opinion stated,

> If the payments are to be regarded as a part of the cost of the machine, then it seems reasonable to allow a corresponding deduction for each year because the payments are measured by the profitable use of the machine in each year and will continue to be so measured during any year in which payments are made.

In *Wall Products, Inc.*,[73] the taxpayer, instead of purchasing a secret process, paid royalties to two principal stockholders (owners of the formula) and succeeded in having the payments allowed as an ordinary and necessary business expense. No "shop rights" were involved here, for the owners of the formula had not been employed to develop the process for the taxpayer. To meet the test of deductible royalties in a situation like this, it is necessary to prove the *existence* of a secret formula, and therefore of a property right.

9. How to Treat Later Reduction in Purchase Price of Property

Where the purchase price of property includes the issuance of obligations which are later reduced or canceled in part, the proper treatment of such cancellation for tax purposes presents a problem difficult of solution, for how gain from the cancellation of indebtedness shall be treated is a much litigated segment of the field of taxation.

When a taxpayer's obligations are assumed by another, or reduced, or canceled as the result of a business transaction, and the taxpayer is thus enriched by the relief from his obligation, taxable income will *generally* result. Business transactions involving a reduction of liability of the purchaser are frequently so complex and varied that it cannot be said categorically that such reduction does, *per se*, produce taxable income. It has long been recognized that cancellation of indebtedness may constitute a gift, a capital contribution, or taxable income. Several decisions have held that a reduction of liability *may* constitute a reduction of the purchase price—and no taxable gain recognized. However, in view of the Supreme

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[72] Par. 51,081, Prentice-Hall Memorandum T.C. (1951).

[73] 11 T.C. 51 (1948).

Court decisions[74] involving treatment of debt cancellation, and the uncertainty of the scope and application of these cited cases as indicated by the Tax Court and the Circuit Courts,[75] it seems clear that a need of clarification exists.[76]

Here we may consider the rule that a prospective purchaser should regard, in the event of discount or adjustment of the purchase price of property. Citing the *Hirsch*[77] case as authority, the courts have frequently held that a solvent debtor does not realize income from the reduction or compromise of indebtedness representing the purchase price of property, *if* the balance paid under the adjustment is not *less* than the market value of the property at that time. A factor requisite to the application of the *Hirsch* doctrine is the decline in value of the property to a point below the unpaid balance of the purchase price. The theory upon which this principle rests is that the cancellation may be regarded as no more than a retroactive adjustment of the purchase price. The *Hirsch* opinion stated,

> Viewing the realistic picture as a whole we see that he purchased the property for $29,000.00, $19,000.00 of which was to be paid in the future. Then came the depression; the value of his purchased asset shrunk to $8,000.00. It was not yet fully paid for; it was not worth paying for; it could not be sold for enough to satisfy the balance remaining unpaid on the purchase price. Caught in this dilemma he negotiated for and secured a reduction of $7,000.00. True, this was a forgiveness of an indebtedness, but, more than that, it was in essence a reduction in purchase price from $29,000.00 to $22,000.00.

In negotiations for the purchase of a plant, or other real property, an understanding or agreement may be reached that if at any time in the future, or perhaps within a limited time such as ten years, you desire to pay all or a large part of the purchase price in cash, the seller will grant a substantial discount. This was the situation in *Pinkney Packing Co.*[78] wherein the petitioner bought a packing plant for consideration of $125,000 in September 1930, that sum being represented by promissory notes due quarterly until September 1940. In 1934, on the basis of the understanding as to the discount for cash, the taxpayer paid $75,000 to the holders of the lien and the renewable notes, and received a clear title to the property, being released from its obligation to pay the full amount of $125,000. The Court held that no taxable income was received in 1934 as a result of this transaction. In all cases where reduction of the debt is treated as an adjustment of the purchase price, the basis (cost) of the property is correspondingly reduced, thereby resulting in more gain or less loss upon ultimate disposition.

Among the obligations and adjustments to which the rule has been applied with a resulting decision that taxable income *was not realized,* are the following: real estate purchase money notes, replaced by notes for lesser amounts;[79] notes for the purchase price of corporate stock, compromised by cash payments;[80] real estate notes and mortgages, compromised by cash payment and new note for lesser amount;[81] land purchase contract, compromised by reduced cash payments.[82]

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[74] U.S. v. *Kirby Lumber Co.*, 284 U.S. 1, 10 AFTR 458 (1931); *Helvering* v. *American Dental Co.* 318 U.S. 322, 30 AFTR 397 (1943); *Commissioner* v. *Lewis F. Jacobson*, 336 U.S. 28, 37 AFTR 516 (1949). See the article by Bruce H. Greenfield, "The Effect of *Jacobson* v. *Commissioner* upon the *American Dental Co.* Case," *Proceedings of New York University Ninth Annual Institute on Federal Taxation*, pages 835-846. New York: Matthew Bender and Company, 1951.

[75] Mertens, *Law of Federal Income Taxation*, Vol. 2, Chapter 11, Sec. 11.19 Chicago: Callaghan and Company 1955. See also Edward First, "How to Handle Bad Debts and Cancellation of Debts," *Proceedings of New York University Eighth Annual Institute on Federal Taxation*, pages 482-485. New York: Matthew Bender & Company, 1950.

[76] For a comprehensive treatise of this general subject see Scott H. Dunham, "Cancellation or Adjustment of Indebtedness," *New York University Seventh Annual Institute on Federal Taxation*, page 1341. New York: Matthew Bender and Company, 1949.

[77] (7 Cir. 1940) 115 F. 2d 656. 25 AFTR 1038.

[78] 42 B.T.A. 823 (1940).

In a purchase transaction where the borrowing of money is *separate* from the purchase of the property, then a later cancellation of the debt has no effect on the basis (cost). In the *Edwards* case,[83] the taxpayer bought shares of stock. To finance the purchase, he borrowed money from a bank and pledged the stock together with other property. Later, his debt was settled with the bank for considerably less than the amount due—at a time when he was insolvent. The amount of the cancellation of indebtedness had been reported as *non-taxable income* in a prior year. Subsequently, the stock was sold and the Commissioner argued for a *reduction* in the cost of the stock, the effect of which would have changed a reported capital loss to a capital gain. But the Tax Court disagreed with this reasoning, stating "We think that . . . the cost of his stock . . . was reduced by a subsequent and totally unrelated cancellation of an indebtedness . . . totally unrelated because creditors, unrelated to the vendor, canceled petitioner's unsecured notes." Had the taxpayer here given his note *to the seller* (with a subsequent partial cancellation) there should follow a basis reduction.

A provision has existed for many years in the 1939 Internal Revenue Code[84] providing specifically that, in the case of a *corporation,* it may exclude from gross income any income attributable to the discharge of indebtedness which is evidenced by a corporate security issued in payment of business property. In connection therewith, consents are to be filed, the effect of which is to reduce the *basis* of the property[85] to the extent that income from the discharge of the indebtedness is excluded. The Internal Revenue Code of 1954 [86] has expanded these provisions so that they are now applicable whether or not the indebtedness discharged was evidenced by a *security* and, in addition, are applicable to the indebtedness of *an individual*—as well as a corporation—where such indebtedness was incurred or assumed in connection with the acquisition of property used in a trade or business.

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[79] *Helvering* v. *A. L. Killian Co.* (8 Cir. 1942), 128 F. 2d 433, 29 AFTR 528.

[80] *Gehring Publishing Co., Inc.,* 1 T.C. 345, 1942 (acq.).

[81] *Kathryn V. Hextell, et al.* v. *Huston* (D.C., Iowa, 1939), 29 F. Supp. 521, 23 AFTR 611.

[82] *Mark W. Allen & Co.,* T.C. Memo. Dec. 1943 (Prentice-Hall Memorandum T.C. Par. 43,168).

[83] *Edward W. Edwards,* 19 T.C. 275 (1952) (Acq.). See also, *Denman Tire & Rubber Co.,* 14 T.C. 706 (1950), affirmed (6 Cir. 1951) 192 F. 2d 261, 41 AFTR 345, *Amphitrite Corporation,* 16 T.C. 1140 (1951).

[84] 1939 IRC Sec. 22(b)(9).

[85] 1939 IRC Sec. 113(b)(3).

[86] 1954 IRC Secs. 108 and 1017.

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What to Do About Section 269 (Old Section 129)

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A number of Internal Revenue Code provisions, as well as certain court decisions, have as their purpose the prevention of specific types of tax avoidance transactions. Such transactions have two noteworthy characteristics: the intent to reduce the amount of the taxes imposed upon the participants, and the determination to effect this purpose by fair means, or alternatively, by means less to the liking of Congress and the courts.[1] Despite the fact that these maneuvers take many forms, they are normally subject to the same indictment: they are characterized by a course of conduct so alien to normal business practice as to appear unrealistic.

The several anti-avoidance Code provisions and court decisions inevitably overlap to some extent. This chapter, however, will be limited exclusively to a discussion of the effect of the provisions of Section 269 of the 1954 Code.

As indicated by the title, 1954 IRC Section 269 is the successor to 1939 IRC Section 129, and, until use has made familiar the section numbers of the new Code, practitioners generally will doubtless continue to refer to this provision by its earlier number.

Aside from certain minor changes of no real consequence, Section 269 includes in its entirety its predecessor. In order to increase its effectiveness, however, a new provision has been added. If an "acquisition" described by the Section is accomplished after March 1, 1954, and if it meets the test prescribed by this new provision, then such shall be *prima facie* evidence that the transaction falls within Section 269.

Because of this substantial identity between the two provisions, the legislative and judicial history of the earlier Section will continue to be of controlling significance in determining the general applicability of the 1954 version. Moreover, since acquisitions consummated prior to March 2, 1954, are actually still governed by the provisions of Section 129, any additional court decisions concerning these older transactions will in the majority of instances be relevant to both Sections.[2]

For these reasons and in order to afford simplicity of presentation this Chapter will be divided into two parts, the first considering transactions occurring prior to March 2, 1954, the second directed to those accomplished thereafter.

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* This article was completed by Robert K. Sands after the death of Thomas O. Shelton.

[1] Not in the criminal sense, but as judged by the rules of fair play.

[2] Many feel that the 1954 changes will have little effect upon the application of the Section.

Part I

TRANSACTIONS ACCOMPLISHED PRIOR TO MARCH 2, 1954

According to the Ways and Means Committee, Section 129 was designed "to put an end promptly to any market for, or dealings in, interests in corporations or property which have as their objectives the reduction through artifice of income or excess profits tax liability." The Section is effective only with respect to taxable years beginning after December 31, 1943. Section 128(c) of the Revenue Act of 1943 provides that "the determination of the law applicable to prior taxable years shall be made as if this section had not been enacted and without inference drawn from the fact that it is not expressly made applicable to prior years."

1. Points to Consider

Your client, or perhaps his wholly owned corporation, contemplates the acquisition of (1) control of another corporation or, (2) the properties of such other corporation. Taxwise, either transaction will benefit the acquiring taxpayer.

	Section
Do the contemplated transactions fall within Section 129?	2
If the contemplated transactions come within the section, what are the consequences to your client?	3
What should you do to avoid or lessen the possibility that Section 129 will apply to your transaction?	4
Note: If the transaction will be accomplished after March 1, 1954, see also Part II of this Chapter.	

2. Does Your Transaction Fall Within Section 129?

The law prescribes two tests for determining whether the particular transaction is condemned. One is objective and the other is largely subjective. In order for a transaction to come within the statute, it is necessary, (a) that it take certain forms and, (b) that the parties carrying out the transaction have a certain purpose and intent:

a. Forms. The transaction must consist of:

1. The acquisition, on or after October 8, 1940, directly or indirectly, of control of a corporation by any person or persons, or

2. The acquisition by a corporation, on or after October 8, 1940, directly or indirectly, of property of another corporation (not controlled, directly or indirectly, immediately prior to such acquisition by such acquiring corporation or its stockholders), the basis of which property in the hands of the acquiring corporation is a substituted basis.

b. Intent. It is necessary that the person or persons in the case of (a)(1) above or the corporation in the case of (a)(2) above, make such acquisitions for the principal purpose of evading or avoiding Federal income or excess profits taxes by securing the benefit of a deduction, credit or other allowance that such person or corporation would not otherwise enjoy.

Of aid in determining the meaning of the statute are the following definitions of the terms employed:

Term	*Meaning*
"Allowance"	According to Regulations, this refers to anything in the Internal Revenue laws that has the effect of diminishing tax liability and includes, among other things, a deduction, a credit, an adjustment, an exemption or an exclusion.[3] According to the Ways and Means Committee, it refers to any provision that has the effect of diminishing the tax liability resulting from the gross amount of any item of income or the aggregate of the gross amounts of any or all items thereof.[4]
"Evasion" or avoidance:	Not limited to cases involving criminal penalties or civil penalties for fraud.[5]
"Federal income or excess profits tax"	Refers to any Federal tax imposed upon an income base.[6]
"Person"	Includes an individual, a trust, an estate, a partnership, a company, or a corporation.[7]
"Principal purpose"	The purpose to evade or avoid Federal income or excess profits tax is the "principal purpose," if the evasion or avoidance purpose outranks, or exceeds in importance, any other one purpose. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result asserted to have arisen therefrom.[8]
"On or after October 8, 1940"	In order to come within the statute, the acquisition of corporate control or of property must have been made on or after October 8, 1940, the date of the second Revenue Act of 1940.[9]
"Control"	The ownership of stock possessing at least 50 per cent of the combined voting power of all classes of stock entitled to vote or at least 50 per cent of the total of all classes of stock of the corporation.[10]

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[3] Reg. 118, Section 39.129-1. Since no Regulations have at this time been promulgated with respect to 1954 IRC Section 269, all references herein are to the Regulations relating to 1939 IRC Section 129. While the changes effected by the 1954 Code will require additional explanation via the forthcoming Regulations, in all probability they will largely conform to those now construing 1939 IRC Section 129.

[4] Ways and Means Committee Report, No. 871, 78th Congress, 1st Session (1943), 49. In order to avoid any implication that 1939 IRC Section 45 (continued without change by 1954 IRC Section 482) was intended in a narrower sense than 1939 IRC Section 129, Section 128(b) of the Revenue Act of 1943 struck out "gross income or deductions" previously contained in 1939 IRC Section 45 (now 1954 IRC Section 482) and inserted in lieu thereof "gross income deductions, credits or allowances." Ways and Means Committee Report, No. 871, 78th Congress, 1st Session (1943), 50. Finance Committee Report, No. 627, 78th Congress, 1st Session (1943), 61.

[5] Reg. 118, Section 39.129-1; Conference Committee Report (House of Representatives Report No. 1079), 78th Congress, 2nd Session (1944), Amendment Nos. 62, 65.

[6] Reg. 118, Section 39.129-1; Ways and Means Committee Report, No. 871, 78th Congress, 1st Session (1943), 49; Finance Committee Report, No. 627, 78th Congress, 1st Session (1943), 61.

[7] Reg. 118, Section 39.129-1.

[8] Reg. 118, Section 39.129-3; Finance Committee Report, No. 627, 78th Congress, 1st Session (1943), 59. Although this is primarily a question of fact, the circumstances surrounding

The relevant Committee Reports and Treasury Regulations furnish certain additional information regarding the required form of transactions falling within the statute and the necessary intent of the person, persons, or corporation carrying out such transactions.

Acquisition of "corporate control" by a person or persons. The statute simply requires that "any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation." The method of acquiring the stock necessary to control is apparently of small consequence.[11] Although the term "indirectly" may raise questions in connection with certain other situations,[12] the Regulations as well as the Committee Reports indicate that it includes that control over a controlled subsidiary resulting from control of the parent corporation.[13]

Thus, the acquisition of control of X Corporation, which owns all of the stock of Y Corporation, is an acquisition of control of both X and Y. Nor is it necessary that all the stock giving the corporate control be acquired on or after October 8, 1940. If A owns 40 per cent of all the voting stock of X Corporation prior to October 8, 1940, and acquires an additional 10 per cent of the voting stock on or after that date, there is an acquisition within the meaning of the statute.[14]

Control that is once acquired over an affiliated group by the parent corporation or its controlling stockholders cannot be again acquired, unless the group is in some way broken. Consequently, if a controlled or affiliated group existed on October 8, 1940, a mere shift in the form of control on or after that date—from direct to indirect, or from one form of indirect to another form of indirect—cannot amount to an acquisition of control for purposes of the statute by the parent corporation or its controlling stockholders.

On the other hand, a transfer of an underlying subsidiary's stock further down the chain may result in the acquisition of control by the intervening subsidiaries. Thus, if X Corporation owns all the stock of B Corporation, which in turn owns all the stock of C Corporation, and X Corporation transfers to C Corporation all the stock of Y Corporation, another wholly owned subsidiary, then this results in an acquisition of control of Y Corporation both by C Corporation and B

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the acquisition will generally be material in determining whether the necessary purpose existed. Reg. 118, Section 39.129-3 provides that the requirement as to principal purpose "does not mean that only those acquisitions fall within the provisions of Section 129 which would not have been made if the acquisition or avoidance purpose was not present." Nevertheless, in many cases, it is believed that the taxpayers will be able to show sufficient business purposes for the acquisition, aside from any tax avoidance purpose, to negate a finding that the latter was the "principal purpose" within the meaning of the statute.

[9] As pointed out by the Ways and Means Committee, "the crux of the devices which have come to the attention of your Committee has been some form of acquisition on or after the effective date of the Second Revenue Act of 1940," with its increased tax rates.

[10] 1939 IRC Section 129(a).

[11] Reg. 118, Section 39.129-3 provides that "if this requirement [requirement of purpose] is satisfied, it is immaterial by what method or by what conjunction of events the benefit was sought"; Ways and Means Committee Report, No. 871, 78th Congress, 1st Session (1943), 49; Finance Committee Report, No. 627, 78th Congress, 1st Session (1943), 60.

[12] Some of these questions are discussed by Charles L. Barnard, in "Acquisitions for Tax Benefit," *California Law Review*, March 1946, Vol. 34, pages 36-86.

[13] Reg. 118, Section 39.129-1; Finance Committee Report, No. 627, 78th Congress, 1st Session (1943), 60.

[14] Reg. 118, Section 39.129-1; Conference Committee Report (House of Representatives Report No. 1079) 78th Congress, 2d Session (1944), Amendment No. 61.

Corporation, but not by X Corporation or its controlling stockholders, since they already held control prior to the transfer.[15] The Regulations state further that if an underlying subsidiary exchanges a part of its assets for all the stock of another corporation, such a transaction will qualify as an acquisition not only by the subsidiary's acquiring the stock of the new corporation, but also by the intervening subsidiaries, the parent corporation, and the stockholders of the parent corporation taken as a group.[16]

The formation by individuals of a new corporation would presumably constitute the required acquisition of corporate control and so meet the statutory requirements as to form. However, because of the fact that the necessary intent required by the statute will in all probability not be present in the ordinary situation, it has been generally assumed that such a transaction is not condemned by Section 129.

Acquisition of property by a corporation. In order for the acquisition of property by one corporation from another corporation to come within the statute, two requirements must be met:

1. The acquiring corporation must secure a substituted basis in the property acquired (that is, the transferor's basis), and
2. the transferor corporation must not have been controlled, directly or indirectly, by the acquiring corporation or its stockholders immediately prior to the acquisition.

The statute plainly has reference to those transactions where the Section 113[17] basis provisions give the acquiring corporation the transferor corporation's basis in the properties acquired, provided also, of course, that the transferor corporation is not controlled by the acquiring corporation or its stockholders immediately prior to the acquisition. This will include Section 113(a)(7)[18] transactions (acquisition of property by a corporation in connection with a reorganization); Section 113(a)(8)[19] transactions (property acquired by a corporation by the issuance of stock or as paid-in surplus); and other Section 113 transactions resulting in an acquisition of the transferor's basis. Section 113(a)(15)[20] transactions (property received by one corporation on complete liquidation of another in a 112(b)(6)[21] transaction) are presumably eliminated from the statute, since in all such cases the acquiring corporation will have control of the transferor corporation immediately prior to the acquisition. It seems probable, however, that the statutory language with respect to control "immediately prior to such acquisition" will be construed in a manner consonant with the purposes of the provision. Although the exception provided by this language would eliminate from the statute transactions otherwise qualified, it appears that the benefits sought by the acquiring corporation might be disallowed under the "acquisition of corporate control" section of the statute in the event that control is acquired for the sole purpose of securing the transferor's property by a transaction resulting in a substituted basis. If, for example, X Corporation should acquire all the stock of Y Corporation solely in order to liquidate Y Corporation, thereby securing property having a low value but an extremely high cost basis, and so entitling the acquiring corporation to a high depreciation allowance or to a loss on sale, then the statute should act to disallow the benefits thus sought to be acquired. Aside from the use of the acquisition of control portion of the statute, such fleeting control (acquired only in order to avoid that portion of the statute bearing on the acquisition of property) might be ignored by the courts as a meaningless and artificial step in the transaction, with the result that the entire operation would be regarded as an acquisition of property within the meaning of the statute.[22]

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[15] Finance Committee Report, No. 627, 78th Congress, 1st Session, (1943), 60.

[16] Reg. 118, Section 39.129-1.

[17] 1954 IRC Sections 1013 through 1091 and Sections 334, 358, 362, 372 and 373.

[18] 1954 IRC Section 362.

[19] 1954 IRC Section 362.

[20] 1954 IRC Section 334.

[21] 1954 IRC Section 332. But see also 1954 IRC Section 334(b)(2).

Requirement as to intent. After prescribing the necessary form of the acquisitions of corporate control or of property, the statute further requires that:

> "The principal purpose for which [either] such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy. . . ."

Most of the uncertainties arise out of this requirement.[23] Although numerous types and forms of transactions would be encompassed by the Section insofar as the requirements as to form are concerned, the "principal purpose" requirement limits, and, based on decisions to date, will substantially restrict the forms that includible transactions may take. Answers to the following questions are essential to a determination of the areas in which the Section is operative:

1. Must the acquiring person, persons, or corporation acquire the corporate control or property for the principal purpose of securing *directly and for themselves* the deduction, credit, or other allowance; or, is it sufficient if their principal purpose is to secure the indirect benefit of such items?
2. In cases involving the acquisition of corporate control, must the principal purpose of the acquiring person or persons be to secure the benefit of a deduction, credit, or other allowance that they would not otherwise enjoy in the absence of control; that is, must the deduction, credit, or other allowance in question *stem from and arise solely by reason of the acquired control?* The same question in connection with the property acquisition portion of the statute is whether the principal purpose of the acquiring corporation must be to secure the benefit of a deduction, credit, or other allowance that it would not otherwise enjoy in the absence of the acquisition of the transferor's basis in the property or properties acquired?
3. What tax advantages are included in the term "allowance"?
4. Assume that the acquiring person, persons, or corporation already possess large deductions, credits, or allowances, but, because they possess no income, are

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[22] In comparable situations the Courts have reached this result without reliance on 1939 IRC Section 129. See *Commissioner* v. *Ashland Oil & Refining Co.* (6 Cir. 1938), 99 F. 2d 588, 21 AFTR 1168; *Koppers Coal Co.*, 6 T.C. 1209 (1946); *Kimbell-Diamond Milling Co.*, 14 T.C. 74 (1950), affirmed (5 Cir. 1951) 187 F. 2d 718, cert. den. 342 U.S. 827 (1951). See in this connection 1954 IRC Section 334(b)(2).

[23] The language causing the greatest difficulty is that added by the Senate Finance Committee to the bill.

receiving no tax benefit from such items. If these taxpayers secure corporate control *for the chief purpose of obtaining income-producing properties to offset their existing deductions*, does such an acquisition come within the statute?

The importance of these questions may be illustrated by a discussion of the examples set out in the Commissioner's Regulations. The Regulations state that "if the requisite acquisition and purpose exist," then the transactions described are within the scope of Section 129. Our purpose is to determine whether, in the illustrations posed by the Commissioner, the requisite purpose in fact can exist. According to the Regulations, the first three examples fall within the acquisition of corporate control provision. The fourth example comes within the property acquisition provision.

Commissioner's example 1: "X" corporation (or the interest controlling such a corporation) with large profits acquires control of "Y" corporation with current, past, or prospective credits, deductions, net operating losses, unused excess profits credits, or other allowances and the acquisition is followed by such transfers or other action as is necessary to bring the deduction, credit, or other allowance into conjunction with the income.

There are a number of different methods by which the large profits of X Corporation can be brought "into conjunction" with the deductions, credits, or other allowances of Y Corporation. Does the manner in which this is accomplished affect the applicability of Section 129? We will assume that, after acquiring Y's stock, X Corporation causes Y Corporation to acquire certain of X's income producing assets, thus simultaneously reducing the latter's own income and causing a part of its income to be offset in Y's hands by Y's deductions, and, further, that X Corporation acquired Y's stock for the principal purpose of effecting such tax savings.[24] It is clear, however, that neither X Corporation nor its stockholders secure directly and for themselves any deductions, credits, or other allowances. X Corporation does benefit by Y's deductions in that X owns all of Y's stock and income that would otherwise have been taxed in X's hands is offset by deductions in Y's hands and so received by Y without the payment of income tax. Does this constitute a transaction condemned by Section 129? The answer depends upon the construction to be given the statutory language, "evasion or avoidance of Federal income or excess profits tax by securing *the benefit of the deduction, credit, or other allowance* which such person or corporation would not otherwise enjoy." The language, "which such person or corporation would not otherwise enjoy," presumably refers to the acquiring person, persons, or corporation. The question is whether the Section should be read as requiring that the acquiring person, persons, or corporation must have the principal purpose (1) of securing (directly) a deduction, credit, or other allowance that it would not otherwise enjoy, or (2) of securing the benefit (directly or indirectly) of a deduction, credit, or other allowance which (benefit) such person, persons, or corporation would not otherwise enjoy. The first construction of the statute would eliminate numerous transactions from within the purview of the statute, particularly those where the acquiring person or persons are individual stockholders.

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[24] Similar results might be accomplished by a merger or a consolidation transaction. But in this connection see 1954 IRC Section 382(b).

That the Tax Court may place such a limited construction on the statute is indicated by dictum found in *Alprosa Watch Corporation.*[25] In this case, a partnership composed of two individuals acquired a large shipment of Swiss watches. On June 14, 1943, the wives of the two partners acquired all the outstanding stock of an existing corporation that had a fiscal year ending June 30 of each year. The corporation not only had substantial losses for the period July 1, 1942 to June 14, 1953, but also had net loss carry-overs and excess profits tax credit carry-overs from previous periods. After the stock was acquired by the partners' wives, the partnership sold all the watches to the corporation at cost, and the corporation resold the watches at a profit prior to June 30, 1943, the close of its taxable year. The Commissioner contended that the corporation should not be permitted to deduct the losses incurred during the period July 1, 1942 to June 14, 1943 or the operating loss carry-overs and unused excess profits tax credits from previous periods. Since the case involved a taxable year beginning prior to December 31, 1943, both parties conceded that Section 129 was inapplicable. The Commissioner contended, however, that the principles set out in Section 129 might well have been the law existing prior to the enactment of that Section. The court said that the parties had not cited, nor had the court been able to discover, any statement of law prior to the enactment of Section 129 "expressive of the specific principles set out in that section."[26] The court then added this observation:

> There is considerable doubt in our minds that even assuming that this case were to be governed by Section 129, the facts constitute a situation condemned by that section. That section would seem to prohibit the use of a deduction, credit, or allowance *only by the acquiring person or corporation and not their use by the corporation whose control was acquired.* (Emphasis supplied.)

It is questionable whether this construction should be placed on the provisions of the statute. Such a limitation not only seriously cripples the effectiveness of the Section, but excludes from its operation many of the transactions that Congress presumably had in mind in enacting the Section.[27] This approach places a premium on the form of the transaction and makes the applicability of the statute dependent upon the manner in which the income is brought "into conjunction" with the deductions, credits, or other allowances. Thus, under this theory, so long as the income-producing assets are transferred to the acquired corporation, the statute would not apply, because the acquiring person or persons would never receive directly for themselves the deductions, credits, or other allowances of the acquired corporation. The statute would apply only in those cases where the acquiring person or persons should secure as a result of the acquisition, the direct benefit of the deductions and other items in question.[28]

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[25] 11 T.C. 240 (1948). The results here would be restricted by 1954 IRC Section 382(a).

[26] The court found that the record in this case did not support a finding that tax avoidance was the dominating motive.

[27] If this construction is correct, Congress actually accomplished what it deliberately attempted to avoid in that the "form and technical character of the scheme" will be of controlling significance. The Senate Committee Report stated: "Section 129, under your committee's amendment, as under the House bill, recognizes that any attempt to encompass tax evasion and avoidance problems by a specific description of the tax avoidance schemes will catch within its net both intended transactions and those not intended and will fail to catch both those intended to be caught and those not intended. Further, the specific description tends to center attention upon the form and technical character of the scheme, and to let the substance of the tax avoidance escape." Finance Committee Report, No. 627, 78th Congress, 1st Session (1943), 60, and: "The House report also recognizes that the legal effect of the section is, in large, to codify and emphasize the general principle set forth in *Higgins* v. *Smith* (308 U.S. 473), and in other judicial decisions, as to the ineffectiveness of arrangements distorting or perverting deductions, credits, or allowances so that they no longer bear a reasonable business relationship to the interests or enterprises which produced them and for the benefit of which they were provided." Finance Committee Report, No. 627, 78th Congress, 1st Session (1943), 58.

In the above discussion, X was the acquiring corporation. Assume, however, that Y, the financially distressed, is the acquiring corporation and that it acquires all the stock of X in order to secure assets producing income that will be offset by Y's deductions. Since Y Corporation had no net income, it derived no tax benefit from the deductions, credits, or other allowances possessed by it prior to the acquisition of income producing properties from X. After such acquisition, it realized a tax benefit from these items for the first time. Apparently, however, this transaction does not qualify as an acquisition within the provisions of Section 129. Since Y already possessed the deductions, credits, and allowances, it is difficult to argue that its principal purpose in securing control of X Corporation was to secure the benefit of such items. Y does not decrease, but actually increases its income as a result of the acquisition. That such a transaction does not fall within the statute is also indicated by the opinion of the court in *Commodores Point Terminal Corporation.*[29]

Another question noted above is whether the acquiring taxpayers must have as their principal purpose the securing of the benefit of a deduction, credit, or other allowance that they would not otherwise enjoy in the absence of control. In other words, must the deduction, credit, or other allowance *stem from and be entirely dependent upon the control acquired?* The answer to this question also determines the particular deductions, credits, or other allowances that will be disallowed by the statute, for it is only "such" deductions, credits, or other allowances (that the acquiring taxpayers would not enjoy in the absence of the acquisition) that are disallowed under the provision. The analogous question raised by the property acquisition portion of the statute is whether the deductions, credits, or other allowances that may be disallowed under this particular provision must *stem from and be dependent upon the acquisition of the transferor's basis in the properties secured.* Again, the answer to these questions depends upon the correct interpretation of the statutory language, "by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy." The question is whether the term "otherwise" refers to all those deductions, credits, or allowances that the acquiring taxpayers would not have benefited from except for the acquisition of corporate control or property, or whether the term refers only to those deductions, credits, or other allowances that result solely from the fact that the acquiring person, persons, or corporation secure control or a transferred basis in the properties acquired. The Tax Court has held that the second and more limited construction of the statute is proper, in *Commodores Point Terminal Corporation.*[30]

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[28] This limited interpretation of the statute would eliminate practically any transaction in which individuals are the acquiring taxpayers. For in such cases the benefits secured will generally be indirect. Nevertheless, certain of the examples reflected by the Committee Reports, as well as by the Regulations, indicate that Congress presumably assumed that the statute would be applicable to acquisitions of control by individual stockholders.

[29] 11 T.C. 411 (1948) (acq.), 1949-1, C.B. 1.

The *Commodores* case involved an "acquisition of corporate control" transaction taking place after October 8, 1940. In this case, W. R. Lovett, an individual, acquired all the stock of petitioner after October 8, 1940. Lovett also owned 58 per cent of the outstanding stock of Piggly Wiggly Corporation and during the latter part of 1944 transferred all this stock to the petitioner corporation in exchange for 15-year trust bonds of petitioner in the amount of $305,000. Some 30 days later, Piggly Wiggly Corporation paid petitioner a substantial dividend. The petitioner's purpose in acquiring the Piggly Wiggly stock was to secure the dividend payments. This would enable it to pay debts, repair and maintain its properties, and pay interest on its bonds. After the transfer, petitioner actually spent some $200,000 for repairs and the construction of new facilities. Lovett's purpose in transferring the stock to the corporation was to build up petitioner's income and permit it to effect immediate improvements and simultaneously reduce his personal income taxes. Urging the application of Section 129, the Commissioner sought to disallow the documentary stamp tax deductions attributable to the issue of bonds to Lovett; the dividends-received credit obtained by petitioner under Section 26(b) on the Piggly Wiggly dividend; and the interest on the bonds paid to Lovett during the year 1944. The court, basing its decision on an interpretation of the statute, held for the petitioner and permitted the deduction of all items questioned. The court discussed the legislative history of the Section, as reflected by the Committee Reports, and pointed out that the Senate qualified the House Bill by adding the phrase, "which such person would not otherwise enjoy. . . ." The court stated that this qualification "limited the applicability of the section to those cases where the deduction, credit, or allowance resulted from, or was attributable to, the acquired control." In this connection, the court said:

> However, control in itself is not determinative. This section condemns tax avoidance only when there is acquisition of control and the employment of that control for the principal purpose of avoiding or evading tax, the acquiring person thereby securing the benefit of a deduction, credit, or allowance 'which such person or corporation would not otherwise enjoy.' *The word 'otherwise' can only be interpreted to mean that the deduction, credit, or allowance, if it is to be disallowed, must stem from the acquired control.* (Emphasis supplied.)

Clearly, the dividends-received credit claimed by the petitioner was not dependent upon petitioner's acquisition of a controlling interest in Piggly Wiggly Corporation, since the petitioner would have received dividends and would have been entitled to claim a dividends-received credit proportionately as great from any number of shares less than an amount constituting a controlling interest. The same was true of the documentary stamp tax deduction and the interest deductions, since the Commissioner could not have challenged these deductions under Section 129, had the purchase involved less than a controlling interest. The court said further:

> Petitioner's purchase of the controlling interest in the Piggly Wiggly Corporation was not, as condemned by the report of the Senate Committee on Finance, an example of

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[30] Footnote 29, above.

> a corporation with large excess profits acquiring a corporation with current, past, or prospective losses or deductions, deficits or current or unused excess profits credits for the purposes of reducing income or excess profits taxes. There is no evidence that such deductions, credits, or allowances existed. The evidence to the contrary, clearly shows that the deductions claimed by petitioner arose from the receipt of dividend payments and were never available to the "acquired" corporation or W. R. Lovett. It is significant that had the petitioner not received these dividends there would have been a net loss for the year 1944 and no tax liability whatsoever.

The court also found that a real and substantial business purpose existed behind this arrangement. The court said finally that the fact that Lovett may have made a tax saving "is of no moment."[31]

The *Commodores* decision, in which the Commissioner has acquiesced, limits the applicability of Section 129 to those corporate acquisition transactions where the principal purpose of the acquiring person or persons is to secure the benefit of some deduction, credit, or other allowance that they would not enjoy in the absence of the control itself. An application of the court's process of reasoning to the property acquisition provision would apparently produce a similar conclusion, that is, that the term "otherwise" refers to those deductions, credits, or other allowances that the acquiring corporation would not have enjoyed except for the transferor's basis in the property acquired. Thus, if X Corporation should acquire from Y Corporation (by a transaction resulting in the acquisition by X of Y's basis) an office building with a high adjusted basis but with an extremely low market value for the purpose of selling the building and taking a loss on the sale, although such loss would be disallowed, any property taxes paid on the building by X would be deductible. The loss would be entirely dependent upon X's securing a substituted basis, whereas the property tax deductions would not.

Commissioner's example 2: A corporation with large profits transfers the assets of each of its branches or departments to newly organized corporations in order to secure the benefit of the exemption provided in Section 710(b)(1).

If the dictum of the *Alprosa* case is correct, then the statute would not apply to this type of transaction. The acquiring corporation would not secure the exemption for itself but would benefit from it only indirectly. Aside from this possibility, however, the transaction would apparently fall within the statutory language. While one dissenting opinion is to this effect, the majority of the Tax Court has to date avoided meeting this question squarely by finding that the transactions were effected principally for business reasons.[32] In the lone District

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[31] The significance of this statement is not entirely clear. The Commissioner's case was based on the contention that the avoidance was accomplished by the acquisition of control of Piggly Wiggly by petitioner corporation. Under this approach, the benefits to Lovett individually would have no significance. Despite the fact that Lovett acquired control of petitioner after October 8, 1940, and admittedly transferred the Piggly Wiggly stock to petitioner in order to reduce his own income taxes, the Commissioner did not attack the transaction on the grounds that it was an acquisition of corporate control by Lovett for tax avoidance purposes. The delay between the acquisition of control of petitioner and the transfer of Piggly Wiggly stock was perhaps the cause for this omission. If the court's statement meant that a benefit to Lovett would have been of no significance regardless of his acquisition of corporate control, then this would apparently be in support of the dictum of the *Alprosa* case.

[32] *Alcorn Wholesale Company, et al.* (1951), 16 T.C. 75; *Berlands, Inc. of South Bend, et al.* (1951), 16 T.C. 182 (acq.), 1951-2, C.B. 1; *Chelsea Products, Inc.*, 16 T.C. 840 (1951), affirmed (5 Cir. 1952) 197 F. 2d 620. In the first two cases, the petitioners formed several new corporations to which were transferred separate sales outlets. The Commissioner contended

Court case considering this question, the court held for the taxpayer and concluded that Section 129 "applies only to a situation where one corporation or one individual acquires new assets" and that, consequently, the formation of a subsidiary corporation could not come within the statute.[33] If this is a correct statement, then a number of situations described by the Committee Reports and the regulations would not fall within the section. Actually, the Committee Reports indicate that Congress was primarily concerned with transactions wherein the acquiring person, persons, or corporation went outside of themselves in order to secure deductions, credits, or allowances from another corporation. Once we assume that the principal purpose of the corporation in the example is to secure the benefit of the exemptions of the new corporations, there seems to be no real reason why the statute should not apply.

A further question concerning the applicability of Section 129 to the formation of a subsidiary corporation is raised by virtue of Section 121(f) of the Revenue Act of 1951 which amended 1939 IRC Section 15 by the addition thereto of Subsection (c). Briefly, Section 15(c), as enacted,[34] provided that if any corporation transfers, on or after January 1, 1951, all or a part of its property to another corporation created for the purpose of acquiring such property or which was not actively engaged in business at the time of such acquisition, and if after the transfer, the transferor corporation or its stockholders or both, are in control of the transferee corporation, then such transferee corporation shall not for such taxable year, "except as may be otherwise determined under section 129(b)," be allowed either the $25,000.00 surtax exemption or the $25,000.00 minimum excess profits credit, unless the transferee corporation can establish "by the clear preponderance of the evidence" that the securing of such exemption or credit was not "a major purpose" of such transfer. Control as used in this section is defined to mean ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote or at least 80 per cent of the total value of all classes of stock of the corporation. The section provided further that the provisions of 129(b), and the authority of the Secretary under such section, shall, to the extent not inconsistent with Section 15(c), be applicable to the latter. In some respects, at least, this section is more restrictive in action

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that Sec. 129 prevented these new corporations from each securing the $10,000.00 excess profits tax exemption. In both cases, the petitioners argued, (1) that Sec. 129 did not apply to such transactions, and (2) that the transactions had a sound business purpose. The Tax Court said that in view of the existence of a sound business purpose, it was unnecessary to consider the other question. In the *Chelsea Products* case, the stockholders of the petitioner had formed three new corporations to act as sales agents of petitioner, and it was the Commissioner's contention (relying on both Section 45, now 1954 IRC Section 482, and Section 129) that the income of the three sales corporations should be taxed to petitioner. The court held that Section 45 did not apply and that the existence of a business purpose precluded the application of Section 129. Judge Opper, joined by three other members of the court, in a dissenting opinion felt that Section 45 was applicable and, referring to the "alleged business purposes" as "flimsy," indicated that this type of transaction was also subject to attack under Section 129.

[33] *J. E. Dilworth Company* v. *Henslee* (D.C., M.D., Tenn., N.D. 1951) 98 F. Supp. 957. The Court of Claims decision for the Government in *Alpha Tank & Sheet Metal Mfg. Company* v. *United States* (December 1, 1953) does not furnish any additional light. While both Section 45 and Section 129 were relied upon by the Government, neither Section was discussed by the Court, the decision being justified solely on the ground that it was necessary "in order to reflect clearly the income of the plaintiff."

[34] Now 1954 IRC Section 1551.

than Section 129. Control requires an 80 per cent stock ownership test rather than the 50 per cent test prescribed by the earlier section. Further, it is provided that this section shall not apply to any taxable year with respect to which the excess profits tax is not in effect. There are other differences. Section 129 is applicable if the tax avoidance is "the principal purpose" whereas the latter section is applicable if the described avoidance is "a major purpose." The area in which the 1951 amendment will operate remains to be delineated by the courts. In the meantime, insofar as Section 129 is concerned, it can and undoubtedly will be argued that the 1951 legislation is to a degree indicative of Congressional recognition that Section 129 does not apply to this type of transaction.

While it expired by its own terms as of December 31, 1953, Section 15(c) has been re-enacted in substantially similar form by Section 1551 of the 1954 Code. If the new section is applicable to the transaction, it also operates to disallow the accumulated earnings credit provided by 1954 IRC Section 535(c), the successor to 1939 IRC Section 102.

Suppose that a corporation with income in excess of $25,000.00 forms various subsidiaries solely to secure the benefit of the lower corporate tax rates resulting from splitting the income. Does this transaction fall within the statute? The answer may well depend upon the meaning of the term, "allowance." The Commissioner states that the term, "allowance" refers to *anything* in the Internal Revenue Laws that has the effect of diminishing tax liability. He then adds that the term includes, among other things, a deduction, a credit, an adjustment, an exemption, or an exclusion. The Ways and Means Committee used similar language but stated that the term referred to any provision that has the effect of diminishing tax liability resulting from the gross amount of any item of income or the aggregate of the gross amounts of any or all items of income.[35] It seems doubtful that Section 129 would apply to the situation posed, in which the corporation's purpose in forming the subsidiaries is simply to divide its income among entities bearing a lesser rate of tax.[36] This type of benefit would not appear to fall within the term "allowance."

The *Commodores* decision raises difficult questions regarding transactions involving split-offs or the formation of new corporations. There the court said that there must be an acquisition of control and the "employment of that control for the principal purpose of avoiding or evading tax," and that "the deduction, credit, or allowance if it is to be disallowed must stem from the acquired control." In that case, however, the court pointed out that the control acquired was incidental to the primary purpose of the acquisition, which was to increase the petitioner's gross income. The court noted also that the deductions in the *Commodores* case arose out of the receipt of income by petitioner and that the deductions were never available to the "acquired" corporation. Although awkward results follow a literal application of the reasoning in the *Commodores* case to the types of acquisitions discussed here, the facts in that case are readily distinguishable from those presented in Commissioner's Example 2, and Example 3 discussed next below. In these transactions, the acquiring taxpayers secure the benefit of the deductions, credits, or other allowances of the acquired corporation. Such benefits do not arise from any additional income acquired. Furthermore, the chief purpose underlying the acquisitions of control in these situations is the securing of these benefits. For this reason, and in order that the statute may apply to such transactions, the courts may limit the reasoning in the *Commodores* case to situations and deductions comparable to those presented there.

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[35] In I.T. 3757, 1945 C.B. 200, the Commissioner held that Section 129 was not applicable to the formation of a Western Hemisphere Trade Corporation, regardless of the fact that the principal purpose in forming the new corporation was to secure the benefits provided by the first exception in Sec. 15(b) of the Code and by Sec. 722(g) of the Code. The Commissioner reasoned that these portions of the Code were enacted by Congress in order to favor any corporation complying only with the terms of the statute, and that no conditions were attached to such allowance. This same reasoning might be applied to some of the situations which the Commissioner contends fall within Section 129.

[36] In this case, the corporation did secure a benefit directly for itself in that it would reduce its own tax rates and at the same time it would benefit indirectly from the fact that the remainder of its income was being taxed in the hands of its wholly owned subsidiaries at lesser rates.

Actually, the Tax Court has been so successful in finding the existence of a business purpose in Section 129 cases that it has not yet been required to answer many of the questions concerning the construction of the statute itself.[37] Many of the questions posed by this chapter still remain unanswered at this date. About the most that can be said is that the Tax Court has been and may continue to be rather liberal in finding the existence of a sufficient business purpose to prevent the application of Section 129. In those cases where the Tax Court has had occasion to discuss the statute, it has indicated that in its opinion the law may not reach a great many situations which presumably were within the intent of Congress. It is interesting to note that the taxpayers have prevailed in every decided case involving this section.

Commissioner's example 3: A corporation with high earning assets transfers them to a newly organized subsidiary retaining assets likely to produce losses or to be disposed of at a loss for the purpose of securing refunds by means of a utilization of the unused excess profits carry-back or the net operating loss carry-back.

As a result of this transaction, the corporation would secure the losses directly and for itself. On the other hand, these losses would not result from the acquisition of control of the newly organized subsidiary. The same result could be accomplished if the corporation sold its assets or if it transferred them to another corporation for less than a controlling interest in the latter's stock. A literal application of the *Commodores* decision would, therefore, exclude this type of transaction from the application of Section 129. The statements with respect to the *Commodores* decision contained in the discussion of the preceding example are similarly applicable here.

Commissioner's example 4: A corporation acquires property, having in its hands a substituted basis that is materially greater than its fair market value at the time of such acquisition, in order to secure a larger excess profits credit, or to utilize the property to create tax-reducing losses.

This transaction clearly falls within the statute. Neither the *Commodores* decision nor the *Alprosa* dictum would affect the applicability of the statute to this type of acquisition.

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[37] *Wage, Inc.*, 19 T.C. 249 (1952) (acq.), 1954 IRB 30, 5. See also A. B. & *Container Corporation*, 14 T.C. 842 (1950).

3. What Are the Results if Your Transaction Falls Within Section 129?

If the transaction falls within the provisions of Section 129, then on its face subsection (a) acts to disallow in their entirety the benefits, deductions, or other allowances sought by the acquiring taxpayers. Congress sought to avoid the inequities that might result from an impartial application of the statute to all cases, regardless of the circumstances involved. By subsection (b) Congress gave the Commissioner broad powers either to allow in part the deductions, credits, or other allowances that would otherwise be disallowed, or to distribute, apportion, or allocate either gross income or such items between or among the corporations or properties involved.[38] The Senate Finance Committee explained this provision as follows:

"Subsection (a) provides for the disallowance in its entirety of the deduction, credit, or allowance which was the objective of the tax avoidance and evasion devices, but in order that the disallowance may be consistent with the purpose and appropriate scope of the section, subsection (b) authorizes the allowance of such part of the deduction, credit, or allowance as will not result in the avoidance or evasion of taxes sought by the acquisition. A proper result can be simply reached under paragraph (1) of subsection (b) in the more widely advertised schemes by reflecting in the deductions, credits, and allowances the purchase in substance by the acquiring interests of the assets which it was the design of the scheme so artfully to conceal. The more complex cases may require the allocation or distribution of any deduction, credit, or allowance between or among the corporations or properties involved. Due to the complex and varied form in which transactions of this character may be cast, the apportionment problems involved will require the specialized knowledge and experience of the Commissioner and his staff. Accordingly, Section 129(b) grants the Commissioner broad authority (of the same kind as that now exercised by him under Sections 45 [39] and 141 [40]) commensurate with the task of determining such proper allowance. Thus, the consideration passing upon the acquisition or the income of the corporations or properties involved, both prior to and after the acquisition, may, in appropriate cases, be an important factor in determining a proper credit, deduction, or allowance." [41]

In acquiring a deduction, credit, or allowance, the taxpayer may simultaneously acquire additional income. Under such circumstances, the Commissioner might allow that part of the deduction, credit, or other allowance attributable or allocable to such additional income.

4. What Can Be Done About Section 129

General comments. It is too early to know what operational limits will finally be established for Section 129. In view of the Congressional purposes underlying the provision, it seems doubtful that the dictum of the *Alprosa* case should be finally fully accepted. The *Commodores* decision, as well as the court's construction of the statute, appears to be sound in the light of the facts there considered. The Commissioner's acquiescence in the decision is evidence of his recognition of this fact. Yet carrying the rationale of the *Commodores* decision to its extreme limits would apparently eliminate from the statute certain transactions that the Commissioner contends are includible. Certainly, many of the benefits secured through an acquisition of corporate control can be acquired to a proportionately lesser degree by an acquisition of corporate stock that is short of control, and so would not "stem from" and be solely "attributable to" the acquired control. The difficulty arising out of a literal application of the *Commodores* reasoning to transactions involving split-offs and the formation of new corporations may mean, as pointed out in this chapter, that the decision will be limited to the type of situation and deductions there involved.

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[38] Ways and Means Committee Report, No. 871, 78th Congress, 1st Session (1943), 49, 50.

[39] Now 1954 IRC Section 482.

[40] Now 1954 IRC Section 1501.

[41] Finance Committee Report, No. 627, 78th Congress, 1st Session (1943), 61; see also Reg. 118, Sec. 39.129-4.

In enacting this Section, Congress was aiming at certain flagrant transactions being undertaken at that time. To the extent that the Section was aimed at other similar types of transactions, Congress was striking out somewhat blindly. The Tax Court's attitude to date may indicate that the statute will be confined to the more noxious transactions in vogue during the excess profits tax era. All in all, it will not be surprising if the Commissioner should fail in any attempt—if indeed he makes the attempt—to bring any great variety of transactions within the statute. This observation should nonetheless be accompanied with a word of caution. When faced with an obvious misuse of one or more Code provisions solely in order to secure an undeserved tax benefit, the courts may abandon the technical approach so far indicated by the Tax Court. In *McWilliams* v. *Commissioner*,[42] the Supreme Court refused to permit a technical and crippling interpretation of the provisions of Section 24(b)[43] of the Internal Revenue Code that would have converted the Section "into a mere trap for the unwary."

What to study. Before undertaking any transaction that might run afoul of the section, one would be prudent to examine the statutory provision with care. In view of the lack of cases interpreting the Section and the generality of the statutory language, the legislative intent of Congress is even more important than is usually true. Consequently, a careful study of the various Committee Reports explaining the purpose of the Section is essential.

Precautions. In reality a large number of harmless, ordinary transactions, by their very form and appearance, may logically be classified within the provision. To the extent that some incidental benefits ordinarily result, they may be questioned. It is probably safe to say that this type of transaction will not be questioned by the Commissioner. This is because of the existence of the "intent" requirement of the statute. On the other hand, certain more flagrant types of transactions will just as obviously fall within the statute. If X Corporation should acquire all the stock of Y Corporation solely in order to secure the high cost basis of assets held by Y (which basis is considerably in excess of the value of such assets), doubtless the attempt would be unsuccessful.

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[42] 331 U.S. 694, 35 AFTR 1184 (1947). The Court said the effectuation of the purpose of Congress (in enacting the Section) "had to be made independent of the manner in which an intra-group transfer was accomplished."

[43] Now 1954 IRC Section 267.

Our concern at this point is neither with the innocuous situation nor the clearly violative transaction. There are numerous in-between transactions that may be seriously questioned under the provisions of Section 129. The tax practitioner will ordinarily recognize these because of the exaggerated tax benefits that follow, or by that particular "feeling" that sometimes develops in him in connection with a case, by reason of its background, or because the results seem too good to be true. Which of these transactions can be defended under the provisions of Section 129?

Unless the proposed transaction is absolutely without justification, it will ordinarily be easy to show some legitimate accompanying business purpose. Many split-ups are accomplished for reasons germane to the business enterprise. The same is true with respect to the acquisition of control of another corporation for the purpose of effecting a merger or consolidation, or with respect to the acquisition of property held by another corporation. If there is a sound business reason for these transactions, there is no reason why they should be struck down under Section 129 simply because they are attended by beneficial tax results. Granted a choice of acquiring the properties of different corporations, the acquiring corporation is not only entitled to do so but should take into consideration the cost basis of the properties that it will secure. If it should wisely acquire those assets that have the highest cost basis, this alone is not sufficient to bring the transaction within the statute. The same may be said of many other transactions that might on their face fall within the statutory provision. It is believed that in a majority of cases, taxpayers will be able to show an adequate business purpose and thereby prevent the imposition of any of the penalties permitted by this Section.

A survey of the picture to date permits certain other conclusions. If the corporation possessing the credit, deduction, or other allowance is the acquiring taxpayer, the transaction has a better chance of survival. Such an acquisition permits the argument that the acquiring taxpayer is not securing the benefit of an allowance, credit, or deduction that it would not otherwise enjoy. Thus, in the situation of Corporation X with large income and Corporation Y with large deduction, it will be better if Y acquires control of X rather than permit X to acquire control of Y.

It seems also true that if the deduction, credit, or other allowance is one that could be secured, in part at least, in the absence of "corporate control" or in the absence of a substituted basis in the properties acquired, the transaction will have a better chance of immunity from Section 129. In such a case, it is clear that the tax benefits do not stem from and are not solely dependent upon the acquired control or the substituted basis.

Restrictions other than Section 129. It does not follow that an escape from Section 129 results in a freedom from liability. The Commissioner has additional arrows in his quiver in the form of various other anti-avoidance statutory provisions, the Regulations, and outstanding judicial decisions. For this reason, many of the transactions that may be eliminated from Section 129 by virtue of a restrictive interpretation of those provisions will be struck down under other sections and decisions.[44]

Part II

TRANSACTIONS ACCOMPLISHED AFTER MARCH 1, 1954

As indicated at the outset of this chapter, 1954 IRC Section 269 includes without material change the provisions of 1939 IRC Section 129. In addition, however, the new law provides "a procedural device for the determination of whether the principal purpose of an acquisition specified" by the Section "was evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance not otherwise available." [45] This is accomplished by the addition of the following subsection:

> Presumption in Case of Disproportionate Purchase Price—The fact that the consideration paid upon an acquisition by any person or corporation described in subsection (a) is substantially disproportionate to the aggregate—
>
> (1) of the adjusted basis of the property of the corporation (to the extent attributable to the interest acquired specified in paragraph (1) of subsection (a), or of the property acquired specified in paragraph (2) of subsection (a); and
>
> (2) of the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such person or corporation otherwise than as a result of such acquisition,
>
> shall be prima facie evidence of the principal purpose of evasion or avoidance of the Federal income tax. This subsection shall apply only with respect to acquisitions after March 1, 1954.[46]

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[44] The Finance Committee said: "Your committee was of the opinion that the section would more effectually secure its objectives if its scope were limited to cases in which the control (more than 50 per cent) of a corporation was acquired on or after October 8, 1940. Such acquisitions are clearly those in which the opportunities for distortion and perversion are largest, both in method and result. Controlled groups are already subject to an express avoidance rule under existing law; and, under your committee amendment, persons acquiring control of a corporation are subjected to the same express rule. "The older types of avoidance scheme which are excluded under your committee's amendment from the scope of section 129, if not within the scope of section 45, will be governed by the principles which have been stated, more fully than elsewhere, in *Higgins* v. *Smith* (308 U.S. 473, 23 AFTR 800), and which, in an increasing number of specific situations, have been applied. *Gregory* v. *Helvering*, 293 U.S. 465, 14 AFTR 1191; *Griffiths* v. *Commissioner*, 308 U.S. 355, 23 AFTR 784; *United States* v. *Joliet & Chicago* R. Co., 315 U.S. 44, 28 AFTR 215; *Moline Properties* v. *Commissioner*, 319 U.S. 436, 30 AFTR 1291; *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 30 AFTR 1310; *National Securities Corp.* v. *Commissioner* (3 Cir. 1943) 137 F. 2d 600, 31 AFTR 456, cert. den. December 6, 1943; and *J. D. & A. B. Spreckels Co.* v. *Commissioner*, 41 B.T.A. 370. As a result, the law applicable to the older types of avoidance, has acquired a definiteness which the law applicable to the newer types involving the acquisition of the control of a corporation, has not. By thus recognizing these different types (which types must necessarily be broad and which must necessarily overlap) your committee believes that the effectiveness of Section 129 will be increased, not only in the prevention of avoidance schemes which defeat the basic policies of the several provisions of the income and excess profits tax law, but also in assisting and facilitating bona fide business transactions in accord with and effectuating such basic policies." Finance Committee Report, No. 627, 78th Congress, 1st Session (1943), 59.

[45] Finance Committee Report, No. 1622, 83rd Congress, 2d Session (1954), 228.

[46] Under the House Bill this presumption was determinative of the fact that the principal purpose of the acquisition was evasion or avoidance of Federal income tax unless the taxpayer by a clear preponderance of the evidence proved the contrary. The *prima facie* version of the Senate was accepted in Conference.

The Commissioner has not yet released the Regulations relating to this section, and the Congressional Committee Reports provide no clear interpretation of the new provision. Some light is afforded by the following statement in the Report of the Ways and Means Committee:

> This provision will apply to cases where the tax basis of the property acquired for depreciation and other purposes, together with the tax value of other tax benefits, such as operating loss carryovers, is substantially greater than the amount paid for the property. Disparities of this type generally arise where the old basis is continued in the hands of the new owner. The corporation in such cases is to be required to establish by a clear preponderance of the evidence that the purpose of the acquisition was not tax avoidance.[47]

The application of such a presumption to a situation wherein the purchase price of the stock of a corporation is substantially less than the corporation's tax basis in its depreciable assets is understandable. With respect to other types of tax benefits, however, questions immediately occur. How will the "tax value" of such other benefits be determined. If this has reference to the amount of the tax savings that will be realized by the acquiring person, will it depend upon his effective income tax rate at the moment of acquisition or his effective income tax rates throughout the periods during which he will realize the benefits. If an individual in a high surtax bracket should be in the position of the acquiring person, could he then lessen the "tax value" of the other tax benefits to be realized by forming a corporation to act as the acquiring person. It will be interesting to see whether the Regulations will attempt to formulate definite standards governing the application of this provision to comparable situations.

While Congress "believed that the addition of this new provision will strengthen enforcement of existing law in an area that has presented a serious tax-avoidance problem," [48] it apparently felt that the section needed further re-enforcement. As indicated earlier, 1939 IRC Section 15(c) was re-enacted as 1954 IRC Section 1551, and any corporation falling within the new provision not only forfeits its $25,000.00 exemption from surtax but also the $60,000.00 accumulated earnings credit provided by 1954 IRC Section 535(c), relating to the tax assessed against corporations improperly accumulating surplus. Moreover, 1954 IRC Section 382 contains new limitations on net operating loss carry-overs. If the ownership of the stock of any corporation shifts to the extent specified by this section and if the corporation does not continue to carry on substantially the same trade or business carried on prior to such shift, the net operating loss carry-over is disallowed. That this new provision was intended to supplement Section 269 is indicated by the Senate Finance Committee which stated:

> If a limitation in this section applies to a net operating loss carry-over, section 269, relating to acquisitions made to evade or avoid income tax, shall not also be applied to such net operating loss carry-over. However, the fact that a limitation under this section does not apply shall have no effect upon whether section 269 applies.[49]

Consequently, even if the stock ownership of the corporation does not shift to the extent specified by Section 382 or in the event that the stock ownership does so change but the corporation continues to carry on substantially the same trade or business, it would seem that Section 269 may be applied to prevent the loss carry-over. On the other hand, if the courts subscribe to the dictum in the opinion in *Alprosa Watch Corporation*[50] then despite the optimistic view of the Finance Committee, Section 269 will not be applied to this type of acquisition. In this connection also, it can be argued that in the light of the widespread publicity given the *Alprosa* case, the re-enactment of this section without change in this respect is some indication of Congressional acceptance of its limited applicability.

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[47] Ways and Means Committee Report No. 1337, 83rd Congress, 2d Session (1954), 32.

[48] Footnote 47, above.

[49] Senate Finance Committee Report No. 1622, 83rd Congress, 2d Session (1954), 284.

It is difficult to predict with any measure of assurance what results have been accomplished by the new presumption set out in Section 269. Certainly, from an administrative standpoint the section is going to pose questions. While the presumption may be of some benefit to the Government in those cases where the purchase price of the stock is clearly disproportionate to the tax basis of properties owned by the acquired corporation, its application to other situations can present a troublesome problem.

Further, unless there is a change in the approach of the courts, the Commissioner is going to be seriously hampered in his ability to attack transactions under the section. Had Congress really desired to strengthen this provision, they could have done the Commissioner a much greater service by so amending it as to eliminate the possibility that it will be accorded the crippling judicial interpretation so far indicated by the courts.

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[50] 11 T.C. 240 (August 31, 1948).

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Selling Business Property

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1. Points to Consider

Sales of business assets often hinge largely upon tax costs, with the general exception of stock in trade or inventory.[1] These costs constitute a major problem of business management, and as such are the concern of this article.

The importance of the subject is manifest by the extent of the analysis of specific transactions afforded in this book.[2] This chapter is devoted entirely to an outline of management approach to the problem, to general and practical aspects rather than to specific and technical points.

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[1] Ordinarily sales of inventory involve only economic considerations, their tax treatment being certain. Occasionally, however, tax considerations mold sales policy even there. For example, loss-leader or premium sales of new products were often found to be inexpensive advertising in excess profits tax years because of the low "profit after taxes" involved.

[2] Reference is made to the Table of Contents, "G. Making Sales and Exchanges," and "H. Making Particular Types of Sales or Purchases." Also, see "Sales Between Related Taxpayers," by Seymour S. Mintz.

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2. Sale Planning

Preliminary. You realize gain or loss on a sale either as ordinary income or loss or as capital gain or loss, depending on the nature of the asset and how it fits into the tax patterns established by the Internal Revenue Code (usually referred to as "IRC"). These different types of gain or loss have both advantages and disadvantages, and much of this chapter will be devoted to their explanation.

Before you have any gain or loss on a sale, you have a right to recover your cost of the property, and unless you get an accurate picture of this cost you cannot arrive at your tax effect. The first thing to do in planning a sale, therefore, is to ascertain your cost.

Roughly, this will be the total of your expenditures for and on the property (not including any costs you have deducted as expenses for income tax purposes) *less* the amount of depreciation allowable, whether it was ever claimed or not. This depreciation reduction can be tricky, especially with an asset on which excessive depreciation was claimed and allowed. If this occurred when your business suffered a net loss, you may have some relief.[3]

Get your costs together, in any case, before you freeze your sale into a fixed pattern. Knowledge of the amount of gain or loss is essential to intelligent planning.

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[3] Sections 1016(2)(B) and 1020, IRC 1954 (IRC § 113(c)(1)(B) and 113(d), as amended by Act of July 14, 1952 (H.R. 3168)), reversing the effect of *Virginia Hotel Co.* v. *Helvering*, 319 U.S. 523, 30 AFTR 1304 (1943). This provision is retroactive to 1913.

Compare tax cost of exchange. Not infrequently, the proceeds from sales of tangible business property are to be invested in the same type of business property. In this case, weigh the relative advantages and disadvantages of an exchange and a sale.

	Advantages	*Disadvantages*
Exchange	No tax on gain if made for property of like kind. If your cost is high, you preserve this higher cost for depreciation or computation of loss.	If your cost is low, you get no increase in basis, and consequently lose higher depreciation. No loss allowable if loss deduction would be an advantage in year of exchange.
Sale	If your cost is low, your realization of partially includible taxable capital gain (if a capital or Sec. 1231 asset held for more than six months) is offset by increase in depreciation (100% deductible).	Immediate tax on gain may be offset by questionable utility of long range depreciation deduction *unless* income is stable. Any loss on sale must be so timed as to be useable.

An exchange to be wholly non-taxable must be without "boot." Otherwise, the "boot" is treated as capital gain realized by the seller.[4]

Timing your sale. A good deal of the advantage in sale planning lies in proper timing of the sale so as to get any gain, or even more particularly any loss, into the most favorable tax year. Income in a high year or loss in a low year are both poor tax tactics. You need to make sound estimates of income to get the best sale pattern for tax purposes.

In planning your sale, the matter of offsets is to be most carefully studied. Under existing law[5] the offsetting of long and short-term capital gains has been simplified and this distinction no longer offers either danger or panacea. But the distinction between assets whose disposition yields ordinary income and those resulting in capital gains is still vital, and you will want to conform your offsets within the categories accordingly. Also, you ordinarily want to be sure you have ordinary income against which your ordinary losses can be offset, although the importance of this may be minimized by net operating loss carry-backs and carry-forwards.[6]

Once you know the factors, you can almost always select one of two years in which to realize your tax consequences, without jeopardizing your sale in any way. This is done by accelerating or deferring the consummation of your sale, after the sale contract itself has been agreed upon. Consummation of sale may mean the delivery of possession of the property unconditionally to the purchaser, as in the case of a land contract, although more usually it means the passage of title to him. The mere execution of a sales agreement is seldom sufficient in itself to cause a consummation of the sale, although an agreement coupled with an offer of both title and possession which was rejected by the buyer was held a completed sale.[7]

A taxpayer reporting income on the *cash receipts and disbursements basis* may defer even further his reporting of income (although not his loss) by deferring the receipt of payments under the contract, so long as he can avoid "constructive receipt." This avoidance requires that the contract itself specify the later time of payment, and that the contract be made in good faith.[8]

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[4] 1954 IRC § 1031(b).

[5] 1954 IRC § 1201 et seq.

[6] See "Net Operating Losses," by David Susser.

[7] *Comm.* v. *North Jersey Title Insurance* Co. (3 Cir. 1935) 79 F. 2d 492, 16 AFTR 804.

A taxpayer reporting income on the *accrual* method, however, usually realizes gain or loss when the sale is consummated regardless of the date of payment. Even here a conditional or contingent transaction might legally defer consummation for a further period, since this would defeat the accrual.[9]

Acceleration of the tax liability seldom presents any problem once the sale is agreed upon. It may at times become most desirable, in order to offset some gain or loss during the current tax year. Delay in reaching an agreement upon a sale can, however, be costly to a seller, if circumstances change the nature of the asset from capital to non-capital.

Piecemeal sale. One answer to timing problems can be a piecemeal, or step-by-step sale, by which selected assets are sold in one taxable year and an executory contract of sale of the rest is entered into to be consummated in another taxable year. Such a sale will conceivably at the same time reinforce an allocation of sale price, provide offset planning between categories, and assure maximum benefits from Section 1231 asset disposals (all gains in one year, all losses in another).[10]

Holding period. Timing of the sale is also of the greatest importance when the holding period of an appreciated capital asset is less than six months. Deferring the sale beyond the six month period in such a case is essential.[11]

Timing your payments. It used to be good business to get as much cash down on a sale as possible, trusting the buyer as little as possible. Taxes have changed this for many sellers. This is because of the advantages of a "deferred payment sale on the installment basis."

That phrase needs some definition. "Deferred payment sale" is simple, being any sale in which payment of a part of the purchase price is deferred to a year other than that of sale. But for tax purposes these sales are either *usual*, i.e., by a dealer regularly selling property which is paid for in installments, or *casual* sales, by other sellers. We are not here interested in the situation of the dealer,[12] but instead in the two classes of sales in the *casual* category.

These classes of casual sales are deferred payment sales (1) on the installment basis and (2) not on the installment basis.

Deferred payment sale on installment basis. The first class is clearly defined by the law and regulations. Its requirements are:

1. It must be a sale of personal property other than inventory for over $1,000, or a sale of real property.

2. It must involve a total of "initial payments" (all payments other than

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[8] *J. D. Amend,* 13 T.C. 178 (1949).

[9] *Burnet* v. *Logan,* 283 U.S. 404, 9 AFTR 1453 (1931) (Gain); *J. Darsie Lloyd,* 33 B.T.A. 903 (1936) (Gain); *First National Corporation of Portland* v. *Comm.* (9 Cir. 1945), 147 F. 2d 462, 33 AFTR 701 (Loss). A taxpayer in this situation must be careful to avoid the effect of *North American Oil Consolidated* v. *Burnet,* 286 U.S. 417, 11 AFTR 16 (1932), holding that the receipt of payments under a claim of right constitutes taxable income even though repayment may depend upon an existing contingency.

[10] See page 776 (this chapter). For a detailed treatment of this entire subject, see "Deferring Sales to Another Period," Thomas E. Jenks.

[11] See "Measuring Holding Period," by Richard G. Moser.

[12] See "Elections in Accounting Methods," by Norman E. Jones.

obligations of the buyer received in the year of sale) not exceeding 30 per cent of the "sale price." The "sale price" may include any mortgage on the property whether or not assumed by the buyer or any purchase money mortgage, but "initial payments" do not include such a mortgage.[13]

3. The seller must elect on his tax return to report his gain on the installment basis, i.e., proportionately as received in each installment.

The option of reporting only a part of the gain in the year of sale gives considerable flexibility to your planning. You can fit your gain to either realized or prospective losses, and defer paying any tax until the gain is actually in hand.

Unless economic reasons or convenience dictate a different answer, it would seem that sale terms coming within the statutory limits would be desirable. By casting the pattern of your sale into this form, you reserve until you file your income tax return for the year, the option of either reporting all of the gain or only the part contained in the initial payments. Such a "reservation of the greater option" is as desirable in sale planning as in other business management.[14]

Installment sale—initial payment. Initial payment cannot exceed 30 per cent of the entire selling price, which includes mortgages outstanding, whether or not assumed. These mortgages are not part of the initial payment, even though assumed by the purchaser,[15] except as to the amount of any mortgage assumed in excess of the seller's basis for the property. In such a case the excess *is* a part of the initial payment to be taken into account in determining whether over 30 per cent was received.[16]

For example, you purchase property for $5,000. You mortgage this property for $10,000, then sell it for $15,000, taking $4,000 down, the purchaser assuming the $10,000 mortgage. Normally, $4,000 being less than 30 per cent of the total selling price of $15,000, this would be an installment sale. But since the buyer assumes the $10,000 mortgage, of which $5,000 was the excess over your cost basis, you are considered as having received an initial payment of $9,000 ($4,000 cash plus $5,000 mortgage assumption) and the sale does not qualify as an installment payment transaction. Payment in notes of a third party would constitute part of initial payment, also, since they are not "obligations of the buyer." [17]

It is worth noting that installment notes of the buyer may be sold to realize in excess of 30 per cent in cash, without destroying the right to report the original sale on the installment basis.[18] This permits additional flexibility where the need for cash conflicts with tax economy.

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[13] The former necessity for at least a nominal initial payment in the year of sale was dispensed with by 1954 IRC § 453.

[14] Loss cannot be deferred, of course, *Martin* v. *Commissioner* (2 Cir. 1932), 61 F. 2d 942, 11 AFTR 1019, cert. den., 289 U.S. 737; *Sacks* v. *Burnet* (D.C. Cir. 1933), 66 F. 2d 223, 12 AFTR 995.

[15] I.T. 2468, VIII-1, C.B. 159; Reg. 118, § 39.44-2.

[16] *Lucas* v. *Schneider* (6 Cir. 1931), 47 F. 2d 1006, cert. den. 284 U.S. 622, 9 AFTR 1044; *Metropolitan Properties Corporation*, 24 B.T.A. 220 (1931); *Burnet* v. *S. & L. Building Corporation*, 288 U.S. 406, 12 AFTR 15 (1933).

[17] G.C.M. 11,846, XII-1, C.B. 113; *Caldwell* v. *U.S.* (3 Cir. 1940), 114 F. 2d 995, 25 AFTR 769.

[18] The full gain realized upon the sale of the notes, however, is reportable as a separate transaction.

Deferred payment sale not on installment basis. The second class, "deferred payment sales not on the installment basis," includes every sale not falling precisely within the first class, because of the absence of one or more of the three requirements of that class, (1) that personal property worth over a $1,000, or real estate, be the subject of sale, (2) the limitation of initial payments to 30 per cent of the purchase price, and (3) the necessity of election to report gain from the sale on the installment basis.

Where, for one reason or another, the terms of sale do not qualify it for such installment basis, you may still defer realization of part of the gain, in certain cases, by agreeing to accept some form of obligation to make later payments. The deferment arises from the fact that these obligations for later payment may not have a fair market value of their face amount on the date you received them.

In this case, the tax result of your sale is a fixed gain (or loss), in the year of your sale, computed either on the basis that the obligations had no fair market value, or that they were worth only a percentage of their face value in that year. Any subsequent income you may receive upon these discounted obligations will be taxed in various ways, often depending upon the nature and form of the transaction in or by which that income is actually captured.[19]

The classic example of this type of situation is where you take a second mortgage to cover the balance due you, unsatisfied by the purchaser's cash resources and the amount he can raise on the first mortgage. Second mortgages are almost invariably discounted because of their junior and speculative nature.

There are some cases where no fair market value whatever can be attributed to the obligations to pay. These are exceptional in nature and ordinarily some market value inheres in the promise, even though it may be highly speculative.

Deferment of tax on the basis of reduced market value, however, can be expensive if you are selling a capital asset held over six months or a section 1231 asset, because of the special tax treatment upon gains from such sales,[20] unless you add another step to the transaction. Before the obligations are paid off by the debtor, you must sell them to a third party, so that the amount of the discount you then realize will be a capital gain in your hands. You will have no difficulty in doing this as a rule, because the purchaser has a cost basis very close to the amount received and will be willing to pay ordinary income rates upon the discount you give him. If your deferred payment sale involves assets other than capital, or Section 1231 assets, you are not hurt by discounting the obligation and deferring the tax and you may be able to convert the discount into capital gains by means of the subsequent sale.

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[19] *Comm.* v. *Caulkins* (6 Cir. 1946) 144 Fed. 2d 482, 32 AFTR 1233; *Lee* v. *Comm.* (7 Cir. 1941) 119 Fed. 2d 946, 27 AFTR 240; *Victor B. Gilbert,* 6 T.C. 10 (1946); *A. B. Culbertson,* 14 T.C. 1421 (1950).

[20] 1954 IRC § 1231 (formerly 1939 IRC § 117(f)(2)): "*General Rule.* If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets . . ." The type of property covered by this section is referred to throughout this article as "Sec. 1231 assets."

Deferred payment obligations—fair market value. The fair market value of deferred payment obligations may vary from zero to 99 per cent in fact, but the Commissioner has indicated a consistent willingness to accept 100 per cent as being fair market value in any given instance. There has been no reported case in which he reduced the value for such an obligation as reported by the taxpayer. Every such case involves an increase by the Commissioner to full value if the taxpayer discounted the obligation, to full or a discounted value if the taxpayer claimed that no market value existed.

Three situations prevail, (1) where no discount is claimed, and the obligation is reported at full value, (2) where the obligation is discounted, partially, and (3) where the obligation is reported as having no fair market value.

Situation 1. Payments received in this case are a return of principal. The tax has already been paid on any profit inhering in this principal and no second tax is due.[21]

Situation 2. In this case a further subdivision is required, depending upon whether the obligor is a corporation. If it is, Sec. 1232 IRC 1954 specifically taxes as non-capital gain the portion of payments currently received or the portion of gain upon sale or exchange which are attributable to the discount.[22] If a corporate obligation is not involved, the portion of current payments from the maker attributable to the discount constitutes ordinary income, but in the absence of statutory change the results of a sale or exchange probably would still be capital gain.[23]

In both cases, however, the portion attributable to the fair market value of the note as returned in the year of sale will be a return of principal and not taxable again, similarly to the payments in Situation 2.

Situation 3. If the note had no value at all, the regulations have up to now given the taxpayer relief. They provide that the payments received on such an obligation shall, after the taxpayers' basis has been fully recovered, constitute a long or short term capital gain if the original transaction involved such a gain.[24]

The *Culbertson* case[25] dramatically emphasizes the danger to taxpayers in these cases. The Culbertsons treated a $10,000.00 note as valueless, and under Situation 3, reported the payment of the note in the following year as a long term capital gain, 50 per cent of which was taxable.

The Commissioner said that the note had a discounted value, with which the Court agreed, ascribing $3,000 of the $10,000 as its fair market value when the sale was consummated. This made $3,000 taxable as a long term capital gain in the year of sale and left $7,000 as the discounted portion of the note, thus bringing the Culbertsons under Situation 2 instead of Situation 3.

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[21] The basis of the obligation is its cost which includes the profit reported. 1954 IRC § 1012, 1016.

[22] Sec. 1232, IRC 1954, is the current modification of Sec. 117(f), IRC 1939, interpreted in *Comm.* v. *Caulkins* (6 Cir. 1946), 144 Fed. 2d 482, 32 AFTR 1233 and *Victor B. Gilbert*, 6 T.C. 10 (1946) (also see § 39.44-4(b), Reg. 118).

[23] This may be clarified by regulation under the 1954 Code.

[24] *Carter* v. *Commissioner* (2 Cir. 1948), 170 F. 2d 911, 37 AFTR 573; *Westover* v. *Agnes F. Smith* (9 Cir. 1949), 173 F. 2d 90, 37 AFTR 1001; Reg. 118, § 39.44-4(c). These cases and *Burnet* v. *Logan* 283 U.S. 404, 9 AFTR 1453 (1931), upon which they are bottomed, all involved contingent obligations, and probably this rule is limited to such cases. Whether the existing distinction between the situations will be perpetuated in the 1954 regulations, however, is questionable.

[25] *A. B. Culbertson*, 14 T.C. 1421 (1950).

As a result the Culbertsons had to report $7,000 in the year following the sale as ordinary income instead of as long term capital gain.

It follows that in this or any similar case, the taxpayer would usually be better off to report the full value of the note and bring himself under Situation 1 so that a long term capital gain is assured.[26]

The foregoing discussion of deferred payment sales has been lengthy, in large part because of the difficulty and uncertainty inhering in treatment of the second class of "deferred payment sales not on the installment basis." Actually, this is the least important of the categories, and most of your tax advantages lie in the use of the installment basis for reporting gain, under the first class. It should again be emphasized that if you can cast your sale in such a form as to qualify for installment basis reporting, this is most desirable, and any other form of deferred payment sale is an alternative of uncertain value.

3. Sale Patterns

So far as we have discussed elements which may be used in any sale, choices which you are going to have to make whatever your business form. The next section, however, is devoted to specific patterns and specific problems arising from the different forms of doing business. These in themselves will exert a very substantial influence upon the pattern of sale which is taxwise for you.

Sale of a sole proprietorship. A sole proprietor selling a part of his business assets, obviously realizes gain or loss from each particular asset sold. There could be no argument of the existence of an entity of any kind which would transform all of these individual assets to a single capital asset.

The situation differs when an entire business is sold. For a considerable period of time the Tax Court inclined to the view that such a sale was unitary in its nature. In 1946, however, Judge Learned Hand, of the U.S. Court of Appeals for the Second Circuit, advanced what he called the "comminuted fragmentation" theory in *Williams* vs. *McGowan.*[27]

Briefly stated this theory is that a sole proprietorship has no entity, and must be broken up into the various categories of assets involved in its operation, upon sale, each category being the basis for the determination of gain or loss depending upon the existing facts.

Since that time the Tax Court adopted this theory and the case has been cited and followed or distinguished in a number of other cases.[28]

At the present time, therefore, the sole proprietor selling his business as an entirety will consider that he is selling a variety of categories of assets, and will make a detailed allocation of his sale price, as later described.[29]

Sale of partnership. In contrast to the sole proprietorship situation, all of the courts considering the sale of a partnership interest held it to be the sale of a single definite asset. The Commissioner finally acquiesced in this "entity" theory.[30]

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[26] Unless barred by later developments, he could also sell the note of an individual obligor, before receiving payments.

[27] (2 Cir. 1946), 152 F. 2d 570; 34 AFTR 615.

[28] *Swiren* v. *Commissioner* (7 Cir. 1950), 183 F. 2d 656, 39 AFTR 781; *Whitney* v. *Commissioner* (2 Cir. 1948), 169 F. 2d 562, 37 AFTR 211.

[29] See page 769 (this chapter).

This has been entirely changed by the 1954 Revenue Code[31] which has in large measure systematized the taxation of partnerships. The entity rule is no longer applicable;[32] but, with a notable exception, a partner selling his entire interest still realizes capital gain or loss on the sale.[33] The exception is that part of the proceeds of sale attributable to unrealized accounts receivable or inventory items substantially appreciated in value. This is considered to be "an amount realized from the sale or exchange of property other than a capital asset" and would result in ordinary income instead of capital gain.[34] In effect, two separate sales are made, one of the selling partner's interest in unrealized receivables and appreciated inventory, the other of the remainder of his interest in the partnership.

The section further defines "unrealized receivables" and "substantially appreciated" inventory items in detail.

The new Code provisions therefore, make allocation of values as imperative upon sale of a partnership interest as upon sale of a sole proprietorship, whether gain or loss results.[35]

Sale of corporation. Sales of corporate property present different problems from sales by an individual or partnership, owing to the double taxation inherent in the corporate form of doing business. The corporation pays a corporate tax upon gain realized from such a sale, and the shareholder pays a second tax, usually upon ordinary income, when the remaining gain is paid to him by the corporation.

There is, therefore, an understandable desire to avoid these two taxes and to substitute a single tax on such gain, payable by the individual stockholder. Three devices have been used to accomplish this elimination of a double tax: (1) liquidation followed by sale of assets, (2) sale of stock followed by liquidation, and (3) distribution of a dividend in property.

The first situation normally involves sale of all or a very substantial part of the corporate assets, and the device used is either liquidation of the company and a sale by the stockholders, or sale by the company followed by complete liquidation. This simple answer, available for almost all corporations other than "collapsible corporations" since June 22, 1954, is made possible by Sec. 337, IRC 1954, which cured a hopelessly uncertain situation under prior precedents.[36]

Sale of stock. An alternative still possessed of advantages in some cases, such as those where preservation of the corporate entity is desired or transferee liability is distasteful, is the sale of corporate stock, which carries with it to the purchaser all of the corporate assets. To make this attractive to the buyer several difficulties often must be met. Some of these are fairly mechanical in nature, such as the unwillingness of the buyer to acquire and pay for some of the corporate assets. This can sometimes be met by selling these or distributing them in partial liquidation to the shareholders, then selling the stock. It should be remembered that such a distribution is taxable as an ordinary dividend if the corporation had earnings and profits.[37] Another such difficulty is the existence of contingent liabilities such as possible deficiencies in federal taxes for past years. Often this can be taken care of by establishing an escrow fund of part of the purchase price.

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[30] GCM 26379, 1952-1 C.B. 58.

[31] Sec. 701 *et seq.*, IRC 1954.

[32] Sec. 701, IRC 1954.

[33] Sec. 741, IRC 1954.

[34] Sec. 751, IRC 1954.

[35] A similar result occurs upon distribution in liquidation of unrealized receivables and appreciated inventory to a retiring partner and his subsequent disposition thereof. See Sec. 735(a) IRC 1954. For a detailed discussion of the subject see "Selling Partnership Interests and Partnership Property" by B. J. Long.

[36] Two Supreme Court cases, *Comm.* v. *Court Holding Co.*, 324 U.S. 331, 33 AFTR 593 (1945) and *U.S.* v. *Cumberland Public Service Co.*, 338 U.S. 451, 38 AFTR 978 (1950) epitomize the artificiality and uncertainty formerly inhering in this situation. See also note, *North Carolina Law Review* 409, Vol. 28, June, 1950.

The principal objection, however, has often been the reluctance of the purchaser to pay a price based upon fair market value of assets held by the corporation with a low basis for depreciation. This objection has been met, except where continuance of the corporate entity for more than 12 months is desired, by the provisions of Sec. 334, IRC 1954, which generally incorporate the doctrine of the *Kimbell-Diamond Milling Company* case.[38]

Property dividend. A special device, of limited value, is the declaration of a dividend of property. This is useful only where the corporation owns property which has appreciated largely in value, and there is no intention of liquidating or selling the corporate business. In such a case the corporation instead of selling the property and realizing a gain can declare a dividend of such property to its shareholders and realize no income. They can then sell the property, paying but the single tax on the dividend itself.

While this avoids double taxation, the tax on the dividend is payable by the stockholder at ordinary income rates measured by fair market value of the property distributed on the date of distribution.[39]

4. Allocation of Sale Price

In general. One of the most important elements in sale planning and negotiation is the allocation of sale price to achieve the best possible tax results. The advantage arises from the income tax principle that the sale or exchange of a capital asset results in a different kind of income from that received from the sale of other assets. This advantage is enhanced by the provisions of Section 1231 IRC with its special treatment of gains and losses on certain non-capital assets.

Any such allocation must, of course, be made to the various categories of assets on the basis of their value, and hence the phrase, "allocation of value," is used throughout. No attempt is made to discuss or even review the subject of asset valuation,[40] but the general principles of such valuation should at least be kept in mind in making your allocation.

Failure to make allocation. If you do not make an allocation, you may be sure the Commissioner of Internal Revenue will do it for you, and will find taxes due as a result. When he does this, you will have the burden of showing that he did it arbitrarily or incorrectly. And since he had the first chance at it, his findings are quite likely to stand unless you can produce something tangible to upset them. The best evidence you can bring in is an allocation of value made at the time of the sale.

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[37] *T. J. Coffey*, 14 T.C. 1410 (1950).

[38] *Kimbell-Diamond Milling Company* (5 Cir. 1951) 187 Fed. 2d 718, 40 AFTR 328, cert. den. 342 U.S. 827 (1951), affirming 14 T.C. 74 (1950); also see *Commissioner* v. *Ashland Oil and Refining Co.* (6 Cir. 1938), 99 Fed. 2d 588, 21 AFTR 1168, cert. den. 306 U.S. 661; *Koppers Coal Company*, 6 T.C. 1209 (1946).

[39] Consider whether this can be treated as a partial liquidation under Sec. 346 IRC 1954. If not, consider whether use of such property to redeem stock qualifying under Sec. 302, IRC 1954, might not afford better tax results than a dividend in your situation.

[40] See "How to Value Property," Alex M. Hamburg.

Allocation by seller alone. Unfortunately, you are not helped too much by an allocation based solely on your own judgment and not part of the negotiations or the sale agreement. Within certain limits, however, such an allocation is persuasive, particularly to a revenue agent. But it must be realistic and justifiable from your special knowledge of the transaction and the property itself, and it must conform reasonably to general valuation principles and procedures.

Allocation by seller and buyer. The most effective allocation of value is that negotiated between the seller and buyer, and preferably incorporated in the sales contract. The Tax Court has gone so far as to say that if there was an actual purchase and sale of a particular asset or type of asset at a fixed price, there is no necessity for another allocation.[41] And the Court has also upheld a specific allocation by the parties in a sales contract, in the face of substantial evidence, found by the trial judge to be true, that this allocation was unreal and fictitious.[42]

Prior to this last decision, however, a contractual allocation was held to be a sham, not reflecting the true agreement between the parties, and the allocation made by the Commissioner was substantially sustained upon the evidence. The Court in this case limited the McCoy decision to "arms-length" sales, a position closer to the traditional pattern of tax law than either of the other two decisions.[43]

The rule may be stated thus:

1. If a buyer-seller allocation in a sales contract is not wholly unreasonable, and is not repudiated by one or both of the parties on litigation, it will probably be sustained.
2. If one of the parties attacks a buyer-seller allocation, and the government defends it, it will be sustained.
3. If the government attacks the buyer-seller allocation and the parties do not unite in defending it, it may fall, but if they do unite, it will stand unless wholly unreasonable and made in bad faith.

Conflicting interests. One reason for the general acceptance of a seller-buyer allocation is that the two have basically conflicting interests in many areas. The buyer will have a quite different set of advantages and disadvantages taxwise resulting from a given analysis of accounts, methods of sale or determination of valuation categories. He will, accordingly, object strenuously to some of your techniques for securing a maximum tax advantage.

Sometimes this situation can be met by concentrating on factors where identical treatment is advantageous to both, such as in valuation of supplies, securities, and depreciable property held as an investment. Ordinarily one or both will make concessions to arrive at agreement. Usually some reasonably satisfactory answer can be found.

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[41] *Thomas J. McCoy*, 15 T.C. 828, 831 (1950) (rev'd on other grounds (10 Cir.), 192 Fed. 2d 486, 41 AFTR 364 (1951).

[42] *Hamlin Trust* v. *Comm.* (10 Cir. 1954) 209 Fed. 2d 761.

[43] *Particelli* v. *Comm.* (9 Cir. 1954) 212 F. 2d 498.

Seller's basic considerations. In general, what you as a seller of property want is the greatest profit with the least tax burden, or the smallest loss with the greatest tax benefit. To accomplish these aims, both the form and substance of each transaction must be carefully examined.

When you are disposing of property at a profit you will want this classified as a long term capital gain in most instances, because of the favored treatment of such income. An individual reports only 50 per cent of his long term capital gain as taxable income and both he and a corporate taxpayer enjoy a maximum rate of tax on the total of their long-term capital gain.

When you sell at a loss you will usually want to realize an ordinary loss which will off-set ordinary income in full. This realization will be secured either by having the asset classified as held for sale to customers or bringing it within the shelter of Sec. 1231.[44]

The following is a tabulation of the favorable and unfavorable tax results which may follow a sale:

Favorable	*Unfavorable*
Long-term capital gain	Short-term capital gain
Ordinary loss	Ordinary gain
Section 1231 gain	Capital loss (usually)
Section 1231 loss	

The problem at this point is, therefore, to allocate the sales price among the various assets sold so as to receive the most favorable tax treatment of gains and losses possible under the facts.

The ideal allocation. The ideal allocation as to gain would be to realize taxable gain only on capital or Section 1231 assets, held over six months. As to loss, in 90% of the cases an ordinary loss is best, being fully deductible without offset. But if you have no net taxable income, a loss on capital assets can be advantageous in that it can be deducted over a six-year income reporting period to the extent of similar gains, plus $1000 of ordinary income per year if you are an individual.

It is, of course, axiomatic that the ideal is seldom reached, by reason of the limitations expressed above, and especially so with reference to the mandatory requirement that the valuation be reasonable.

Basic Aims. The rule covering general categories is so to allocate value as to realize:

1. Long-term capital gain on capital assets.
2. Section 1231 gain or loss with a minimum of offset.
3. Loss on other noncapital assets.

Reasons:

1. A long-term capital gain is included for tax, practically speaking, at 50 per cent of its amount, and has a maximum tax rate of 50 per cent of the amount includible (25 per cent of the total gain).

2. A capital loss is deductible at 100 per cent of its amount, but has the general defect of being usable only to offset capital gains plus $1,000 of ordinary income in any one year. It may, however, be carried over to the succeeding five years for

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[44] See footnote 20.

the same purposes. This privilege may be of considerable value in a given case.[45]

3. Ordinary loss on noncapital assets is deductible in full from income.

Definitions. Long-term capital gains and losses are those resulting from sale or exchange of capital assets held for more than six months.

Capital assets comprise all property that is not included in one of the following classifications:

1. Stock in trade or other property which would properly be included in your inventory if held at the end of your taxable year.
2. Property held primarily for sale to customers in the ordinary course of your trade or business.
3. Real estate or depreciable property used in your trade or business at the time it is sold or exchanged. (Section 1231 provides special treatment if held over six months.)
4. Federal, state, or municipal obligations issued at a discount after March 1, 1941, bearing no interest and due in a year or less from date of issue.

5. Valuation Planning—Capital Assets

On capital assets you will realize capital gains or losses, either long- or short-term. If your holding period is over six months, you have either a long-term gain, which we have seen is favorable, or a long-term loss, which is unfavorable. If a net gain is therefore to be realized from the sale, a high value for such assets is desirable. If a net loss, a low value is to be preferred.

A holding period of under six months suggests a contrary answer—value neither high nor low, but regain your cost if you can. Any loss is a short-term capital loss and is therefore usually less valuable taxwise than an ordinary loss, whereas any gain is fully taxable and without distinction from an ordinary gain, except insofar as it is available to offset capital losses.

What are capital assets? Translating the phrase "capital assets" into everyday business experience, we find included therein notes and accounts receivable, uninventoried supplies and similar items, stocks, bonds, and securities, land or real estate not used in business, good will. To all of these you will try to apply the general rules outlined. And as to any of them, except notes and accounts receivable, supplies, and investments in stocks, you will find strenuous objections from the purchaser who wants to get back his purchase price or its equivalent, tax-free, and in a hurry.

It must always be remembered that a "Stop, look, and listen!" sign confronts you before you finally classify a capital asset. Ask yourself the question, "Could this be construed to be property primarily held for sale to customers in a trade or business?" Do not dismiss this too lightly. The customs of a business may reverse the usual rule completely.

Securities. Stocks, bonds, and other securities pose this basic problem of classification, but here it is susceptible of a quite precise answer.[46] It is clear that mere trading in securities does not make the securities assets held primarily for sale to customers.[47] Dealers in securities, as opposed to mere traders, can be rather easily classified.

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[45] The distinction between the long and short-term capital gains is material to corporations only because the alternative maximum tax rate is applicable to corporate net long-term capital gains. 1954 IRC § 1201. A net capital loss is of less value to corporations than to individuals, being only available to off-set later capital gains. 1954 IRC § 1211.

Real estate. Land also presents no very substantial problem unless held for sale to customers. It either has some logical connection with a business or it has not, and you can ordinarily determine the connection to your own satisfaction. Even if there were a change in classification from that of capital assets, unless you are a dealer in real estate, it would probably go into another category—Section 1231 assets—in which a relatively favorable treatment is assured.

Income-producing real estate is pretty certain to be a Section 1231 asset, except to a dealer.[48] Consider production of rental income to be the dividing line between capital and Section 1231 assets in this category.

Goodwill. Goodwill, as such, poses no problem. It is a capital asset.[49]

It is usually the necessity of sustaining a claimed allocation to good will that it is troublesome. The burden of proving such an allocation rests upon the seller.[50]

Payments not to compete are ordinary income, as a rule, but may be changed to capital gain if you can make them supplemental to and protective of goodwill.[51]

In one case a covenant not to compete was held "ancillary" to goodwill in spite of a contract allocation of purchase price.[52]

Trade-names are analogous to good will and are capital assets.[53] So are franchises,[54] although if the franchise is for a limited duration, it would seem to be a Section 1231 asset, being depreciable business property.[55]

How to handle life insurance. One type of capital asset requiring special scrutiny is life insurance. It is often doubtful whether the sale of life insurance policies is advisable, and the facts of each case must be carefully studied in the light of the tax consequences that may be incurred. The seller would in every case realize a capital gain or loss on the difference between what he had invested in the policies and the amount for which they are sold. As a rule, however, unless the policies have been long outstanding, sale would result in a relatively undesirable capital loss, since cash surrender value would ordinarily measure the amount to be received. Usually this does not equal the total premiums paid for some years after issuance of a policy. At the same time, if the policies are old enough to have a sale value in excess of the cash surrender value, it is likely that they also have a substantial speculative value and hence might be worth more than could be realized on sale.[56]

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[46] *Joe B. Fortson*, 47 B.T.A. 158 (1942); *Hercules Motors Corp.*, 40 B.T.A. 999 (1939); and for rules regarding dealers also trading in securities, see *Stifel, Nicolaus Co., Inc.*, 13 T.C. 755 (1950); *Van Tuyl*, 12 T.C. 900 (1949); I.T. 3891, 1948-1 C.B. 69.

[47] *Commissioner* v. *Burnett* (5 Cir. 1941), 118 F. 2d 659, 26 AFTR 893.

[48] But see footnote 80 below relating to real estate "held for sale."

[49] *Ensley Bank & Trust Co.* v. *U.S.* (5 Cir. 1946), 154 F. 2d 968, 34 AFTR 1164, cert. den. 329 U.S. 132; *Horton*, 13 T.C. 143 (1949); *Richard S. Wyler*, 14 T.C. 1251 (1951).

[50] *Grace Bros. Inc.* v. *Commissioner* (9 Cir. 1949), 173 F. 2d 170, 37 AFTR 1006.

[51] *Aaron Michaels*, 12 T.C. 17 (1949); *Toledo Newspaper Co.*, 2 T.C. 794 (1944).

[52] *Toledo Blade Co.*, 11 T.C. 1079 (1948), affirmed (6 Cir. 1950), 180 F. 2d 367, cert. den. 340 U.S. 811 (1950). For an extended treatment, see "Setting Up Covenants Not to Compete," by O. Carlysle McCandless.

[53] *Rainier Brewing Co.*, 7 T.C. 162 (1946), affirmed (9 Cir. 1948), 155 F. 2d 217, 36 AFTR 519.

[54] *Constantine H. Kavalaris*, par. 46,005, Prentice-Hall Memorandum, T.C. (1946).

[55] *John C. Burns Estate*, par. 47,242, Prentice-Hall Memorandum, T.C. (1947).

There will be situations, however, where the insurance would be of no value to the seller, by virtue of the burden of maintenance, or for some other reason. In these cases, endeavor to get a gain or at least return of the amount paid, because any loss sustained is a capital loss.

6. Valuation Planning—Non-capital Assets

Inventory. Turning to non-capital assets, we find that inventory, in general, consists not only of stock in trade but of all raw materials and supplies, including partly or wholly finished articles that become part of merchandise sold in your business operation. Sale of inventory as such always results in ordinary gain or loss. Aim at selling inventory for its cost to you or less. But segregate all supplies that are not to be incorporated in merchandise sold. Sale of these will usually result in capital gain if they bring more than their cost.[57]

Property primarily held for sale to customers in a trade or business presents a far more difficult problem of classification. You must be engaged in a trade or business, but even if you are, the asset must be "held *primarily* for sale to customers in the *ordinary* course of the trade or business," and this is difficult of definition.

Real property. The bulk of the decisions deal with the classification of real property. These decisions are so great in number and so varied in factual situation that discussion of any except those of widespread and general interest has not been attempted in this article. Investment real estate, even though held by a builder,[58] or a dealer,[59] can be a capital asset, whereas, subdivision real estate may, depending on the facts, be either capital or non-capital.

Statutory rule on subdivision real estate. The classification of sales of lots from real estate subdivisions was particularly troublesome administratively for both taxpayer and the revenue agents prior to 1954. The 1954 Code by substituting a largely objective set of rules made the classification easier for individuals, but not corporations. Capital gain can be realized, under very specific conditions, on up to five lots sold from a particular subdivision (and perhaps more under some circumstances). On further sales from such a subdivision, gain up to 5 per cent of the purchase price is considered ordinary income and the remainder of the gain is still capital in nature.

Principal rules are:

1. Seller cannot be a corporation or a real estate dealer in year of sale;
2. No substantial improvements can have been made directly or indirectly by seller, increasing the value of the lots sold;

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[56] Insurance proceeds at maturity are ordinary income to the buyer, unless he is the insured or acquires the policies in a reorganization. Although these proceeds can be changed to capital gain by sale before maturity, it adds to his reluctance to pay substantial amounts for the policies.

[57] A rare exception exists where a trade practice, consistently followed since a period prior to 1933, called for inventory of this type of supplies.

[58] *Ben L. Carroll,* 21 B.T.A. 724 (1931).

[59] *Nelson A. Farry,* 13 T.C. 8 (1949).

3. Lots were held for five years (unless inherited or a gift).

The law should be carefully checked for other limitations and provisions.[60]

Corporations owning subdivisions, and presumably all individual owners not qualifying under the Code, will be governed by the law as judicially developed before 1954, with perhaps a little more difficulty in getting a favorable classification if any change is noticeable in interpretation.

Judicial rules on subdivision real estate. It is difficult to draw hard and fast lines of distinction in the cases involving subdivided real estate generally, but a general pattern emerges. Purpose of acquisition, the manner of making sales, and the number of sales made are all strongly determinative factors. Generally speaking, when purchase for resale is combined with either active methods of disposition or a large number of sales, the property is held to be for sale to customers.[61] In several cases it was so held where real estate had been acquired for resale, even though sales were sporadic and unsolicited.[62] Sales activities alone have also been held to be enough to classify property as held for sale to customers.[63] A substantial number of sales by a real estate broker shortly after acquisition in his own name and for his own account had the same result.[64]

On the other hand, acquisition for reasons other than resale, combined with inactivity as to sales promotion, have resulted in a determination of capital gain or loss in many cases.[65] In one case where certain active sales promotion was engaged in, the court found itself impelled to conclude that it was merely part of an "orderly liquidation" of a tract purchased for an unrelated (and completely accomplished) purpose,[66] but generally the liquidation theory has been disregarded as immaterial, or has been applied in cases where sales activity was negligible.[67]

At least one decision witnesses that a seller can be said to have changed his mind. The taxpayer bought property for resale, abandoned his intention to resell for many years, and at last sold two parcels for nominal amounts. His losses were held to be capital, over his vociferous objections.[68]

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[60] Sec. 1237, IRC 1954.

[61] *Gruver* v. *Commissioner* (4 Cir. 1944), 142 F. 2d 363, 32 AFTR 662; *Welch* v. *Solomon* (9 Cir. 1938), 99 F. 2d 41, 21 AFTR 847; *Snell* v. *Commissioner* (5 Cir. 1938), 97 F. 2d 891, 21 AFTR 608. See also *Winnick* v. *Comm.* (6 Cir. 1952) 197 F. 2d 374.

[62] *George Wibbelsman,* 12 T.C. 1022 (1949); *Walter G. Morley,* 8 T.C. 904 (1947); *Factoria Land Co.* (1947), par. 47,051 Prentice-Hall Memorandum T.C. The same result was reached where no sale was made except of the entire tract, *Charles Dorrance* (1947), par. 47,164 Prentice-Hall Memorandum T.C.

[63] *Ethel S. White* v. *Commissioner* (5 Cir. 1949), 172 F. 2d 629, 37 AFTR 904; *C. W. Oliver* v. *Commissioner* (4 Cir. 1943), 138 F. 2d 910, 31 AFTR 864; *Ehrman* v. *Commissioner* (9 Cir. 1941), 120 F. 2d 607, 27 AFTR 482; *Spanish Trail Land Co.,* 10 T.C. 430 (1947).

[64] *Eddy T. Field* (1949), par. 49,043 Prentice-Hall Memorandum T.C. aff'd *per curiam,* 180 F. 2d 170, 38 AFTR 1495; *Thomas Ryan* v. *U.S.* (D.C. Texas 1952), 107 F. Supp. 553, 42 AFTR 775. See also *Brown* v. *Comm.* (5 Cir. 1944), 143 F. 2d 468, 32 AFTR 1007.

[65] *Freda E. J. Farley,* 7 T.C. 198 (1946); *Thompson Lumber Co.,* 43 B.T.A. 726 (1941); *Viggo Gruy* (1950), par. 50,068 Prentice-Hall Memorandum T.C.; *Dagmar Gruy* (1949), par. 49,217 Prentice-Hall Memorandum T.C.; *Minnie S. Loewenberg* (1948), par. 48,197 Prentice-Hall Memorandum T.C.; Estate of *Alice G. K. Kleberg* (1946), par. 46,242 Prentice-Hall Memorandum T.C. See also *Houston Deep Water Land Co.* v. *Scofield* (D.C. Texas, 1952) 110 F. Supp. 394, 43 AFTR 497.

[66] *Three States Lumber Company* v. *Commissioner* (7 Cir. 1946), 158 F. 2d 61, 35 AFTR 357; also see *Fahs* v. *J. T. Crawford* (5 Cir. 1947), 161 F. 2d 315, 35 AFTR 1228; *W. D. Haden Estate* (1953), par. 53, Prentice-Hall Memorandum T.C.; *Viggo Gruy* (supra, note 64).

[67] Generally, liquidation is not a valid test if sales and promotional activity indicate actual conduct of a business, *Frieda E. J. Farley* (1946) 7 T.C. 198; *Victory Housing No. 2 Inc.* v. *Comm.* (10 Cir. 1953), 205 F. 2d 371. Compare, however, *Rollingwood Corp.* v. *Comm.* (9 Cir. 1951), 190 F. 2d 263, 40 AFTR 1606.

Other non-capital assets. Timber held by lumber dealers has been held to be a capital asset,[69] but a leading case held a retired investor taxable on the full price of timber sold by him from large holdings.[70] A lease broker holding leases purchased for investment may have a capital asset,[71] and a security dealer properly identifying securities he holds for investment may treat these as capital assets.[72]

Oil and gas leases have a character all their own and have been the subject of much litigation. Generally, if the sale of oil and gas rights constitutes a sale of mineral in place, it is sale of an asset. But a sale of royalty rights is simply an anticipation of income, not a true sale price, and constitutes ordinary income to the seller. The determination of which situation exists is highly technical and depends on the facts in each case.[73]

It is worthy of note that a change of use "for the time being" from noncapital to capital has been held ineffective in changing the tax status of a gain. The change in use in this case continued for eleven years, but still did not suffice to change the category.[74]

In your determination of property held primarily for sale to customers, resolve all doubts in favor of the Commissioner, as in most tax cases. Insofar as possible, so value property that might be classified in this category as to realize a minimum of gain.

7. How to Get Full Benefit of Section 1231

We have covered all but one of the major tax categories of capital and noncapital assets. The one remaining is in many respects the most important of all, because it offers the maximum flexibility and benefit from tax planning of sales.

Real estate and depreciable property used in trade or business and held more than six months is generally referred to throughout this article as "Section 1231 assets." This is because this category of noncapital assets is given special tax treatment, generally favorable to the taxpayer. This treatment requires rather extensive discussion and illustration.

Briefly, any net recognized gain from sales, exchanges or involuntary conversion of Section 1231 assets is considered as a long term capital gain, whereas any similar net loss is treated as an ordinary loss. By "net" is meant the total result of all such transactions in the year.

For example, consider the following transactions in a single accounting period:

	Gain	*Loss*
1. Gain on deferred payment sale of business real estate held over six months	$5,000	
2. Gain on condemnation of farm held over six months		

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[68] *James L. Vaughan* (1948) par. 48,076 Prentice-Hall Memorandum T.C. But see *Mauldin* v. *Comm.* (10 Cir. 1952) 195 F. 2d 714, 41 AFTR 1126 for reverse of this picture.

[69] *Camp Manufacturing Co.,* 3 T.C. 467 (1944); *J. J. Carroll,* 27 B.T.A. 65 (1932).

[70] *Commissioner* v. *Boeing* (9 Cir. 1939), 106 F. 2d 305, 23 AFTR 350.

[71] *Foran* v. *Commissioner* (5 Cir. 1948), 165 F. 2d 705, 36 AFTR 698.

[72] 1954 IRC § 1236.

[73] See, "Oil Investment," George E. Ray and Oliver W. Hammonds.

[74] *Neils Schultz,* 44 B.T.A. 146 (1941).

	Gain	Loss
(not replaced)	7,000	
3. Loss on sale of machinery used in business, held over six months		$8,000
4. Loss from storm—business property held over six months, not reimbursed		1,000
	$12,000	$9,000

Net gain of $3,000 is included at $1,500 or 50 per cent in taxable income, and maximum tax is $750. If total gain had been $9,000 and total loss $12,000, the net loss of $3,000 would be deductible in full from ordinary income.

The only tax drawback to this treatment of gains and losses is that what would be capital gain taxable at 50 per cent offsets what would be an ordinary loss deductible in full. Ideally, you would therefore take all *gains* under this section in one year, all *losses* in another, thus making two sales instead of one. This as a rule is impracticable, but the closer you come to it the better the tax answer. In every case, valuation of this type of assets should aim at realizing as much net gain on one hand, or as much net loss on the other, with a minimum of offsets, as is reasonably possible under the circumstances.[75] In other words—high value where a group of Section 1231 assets will be sold for a net gain, low value for a net loss transaction.

Examples of property coming under Section 1231 are machinery and equipment subject to depreciation, patents, leaseholds and real estate, all of which (a) must have been used in business at the date of sale and (b) held over six months.

What are Section 1231 assets? The two necessities in classifying Section 1231 assets are to identify them as being *used* in a trade or business, and as either real estate or property "of a character subject to depreciation." Use in a trade or business is obviously a question of fact, subject to a few general rules, exemplified in the decisions previously discussed.

1. A person may be engaged in a number of businesses, devoting a nominal amount of time to some.
2. Businesses may be conducted solely by agents or brokers.
3. The extent and nature of activity—regular and substantial as opposed to sporadic, occasional or insignificant transactions—are of great importance.
4. The existence of property held for sale to customers is of special significance, particularly if it was acquired for resale.

The extent of use has been occasionally argued as a point of consideration, especially where sale terminates such use. This seems to have been concluded in favor of the taxpayer.[76]

Regulations provide for applicability of Sec. 1231 if the property was used in a trade or business on the date of sale. The usual case, however, is of property previously used in business but not so used at the date of sale. This has been generally answered in favor of application of the special statutory classification.[77] But land inherited and held only for sale did not come under the statute,[78] nor did land that could not have been used in business.[79]

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[75] It is to be noted that this recommendation and the objection that it answers has no application to corporate sellers of property, since their capital gains are all includible at 100 per cent.

[76] *John D. Fackler* v. *Commissioner* (6 Cir. 1943), 133 F. 2d 509, 30 AFTR 932.

[77] *Carter-Colton Cigar Co.*, 9 T.C. 219 (1947) (land); *Solomon Wright, Jr.*, 9 T.C. 173 (1947) (land); *Wilson Line, Inc.*, 8 T.C. 394 (1947) (marine railway).

The question of criteria for determining use in business of specific types of property is primarily a factual question, especially as relating to machinery, equipment and patents. As to improved real estate, however, there is a well-defined rule that rental of such real estate constitutes a business in itself, separate from dealing in real estate.[80]

Conversion of residence to rental property. What about conversion of residences into property used in a trade or business? There are a number of decisions holding that this conversion is accomplished by actual rental, and that the value of the property is its fair market value on the date of such rental.[81] But the courts have almost unanimously held that failure to rent the property was fatal to a claimed conversion, regardless of efforts to secure tenants.[82] It is true that most of these cases involved simultaneous attempts to sell the property, but this was not universally true and cannot therefore be considered controlling.

Leaseholds would seem logically to fall into the same class, and there is some authority for such a holding,[83] but it cannot be said to be conclusive.

Unimproved land. Unimproved real estate is somewhat different, even when income producing. It involves no such management or supervision requirement as does rental property. Nevertheless, if land is rented, except in a single isolated transaction, it probably would be regarded as coming under Section 1231. Unrented land, however, unless originally acquired for business use and not abandoned, would be a capital asset rather than a Section 1231 asset. The difference is seldom very important, except in netting gains or losses from the latter type of property. It probably would be safe to assume that all unimproved land now rented or used directly in business, or originally acquired for direct use in business, would be a Section 1231 asset, whereas all other land would be a capital asset.

Patents. Patents, another Section 1231 asset, may be held and used by a manufacturer in conducting his business. In such a case, they would be identical with machinery and equipment and other depreciable property held by him. But in addition to such use, patents might be held by an inventor or others who are engaged in the business of licensing manufacture by other persons. This likewise has been held to be use in business.[84]

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[78] *Richard E. Beck* (1949), par. 49,031 Prentice-Hall Memorandum T.C., See also *Thora S. Ronalds* (1946), par. 46,224 Prentice-Hall Memorandum T.C.

[79] *Montell Davis,* 11 T.C. 538 (1948).

[80] *John D. Fackler,* 45 B.T.A. 708 (1942), affirmed (6 Cir. 1943), 133 F. 2d 509, 30 AFTR 932; *Leland Hazard,* 7 T.C. 372 (1946), *acq.* The decision in *Annie Gibney Estate* (1945), par. 45,290 Prentice-Hall Memorandum T.C., shows the strength of this rule. The factors of (1) involuntary acquisition, (2) temporary nature of holding, (3) insignificant gross income, and (4) continual net loss were all unavailing to defeat view of the operation of the real estate as a business.

[81] *Heiner* v. *Tindle,* 276 U.S. 582 (1928); *Kimbell,* 41 B.T.A. 940 (1940); Reg. 118, § 39.33(e)(1) (interpreting 1939 IRC § 23(e)(2), now 1954 IRC § 165(c)(2), which has been in the law without material change since 1918). Permission to others to occupy rent-free does not accomplish conversion. *Romberger,* 4 B.T.A. 523 (1926) (friend); *Estate of Walter Davidson* (1946), Memorandum T.C. (son); *Emmet,* 11 T.C. 90 (1948) (Charities).

[82] *Rumsey* v. *Commissioner* (1936), 82 F. 2d 158, 17 AFTR 577, cert. den. 299 U.S. 552; *Morgan* v. *Commissioner* (5 Cir. 1935), 76 F. 2d 390, 15 AFTR 1130, cert. den. 296 U.S. 601; *Robinson* v. *Commissioner* (3 Cir. 1943), 134 F. 2d 168, 30 AFTR 1047; *Warner* (1947) par. 47,144 Prentice-Hall Memorandum T.C., affirmed (2 Cir. 1948), 167 F. 2d 633, 36 AFTR 973. A distinction is made as to inherited property not used as a personal residence by the devisee or heir after acquisition. An effort to rent such property is enough to establish use in a trade or business. *Crawford,* 16 T.C. 678 (1951); *N. Stuart Campbell,* 5 T.C. 272 (1945); *George W. Carnrick,* 9 T.C. 756 (1947).

[83] *Fackler* v. *Commissioner* (6 Cir. 1943), 133 F. 2d 509, 30 AFTR 932; *Pekras* v. *Commissioner* (6 Cir. 1944), 139 F. 2d 699, 31 AFTR 1127, cert. den., 322 U.S. 739.

The classification of property as depreciable or subject to exhaustion would seem a clearly identifiable group, including business leaseholds and patents. Its propriety has been questioned, however, in cases where no cost existed and where no depreciation had been claimed. The courts have, however, pointed to the words "of a character subject to" (exhaustion or depreciation) as eliminating the need of a basis for or allowance of actual depreciation.[85]

Leaseholds. It may be pointed out that in connection with leaseholds there arises a question of whether a "sale" is actually being made. It has been held that transfer of a lease from a lessee to a lessor, for consideration paid to the lessor, was not a true sale, being merely an anticipation of rental thereafter due. But transfer of a lease for a consideration running to the lessee has been held a sale when transferred to others than the lessor,[86] or to the lessor[87] and there appears no logical basis for differentiation.[88]

Property held for sale to customers. When is a Section 1231 asset held primarily for sale? Your last and often most difficult requirement is to make sure that the assets do not qualify as property held primarily for sale to customers. The preceding discussion of this point in connection with capital assets has indicated the general problems presented. Section 1231 assets offer both these and new questions.

When is real estate held primarily for sale? The capital asset discussion related primarily to land. A few decisions relating to real estate as a Section 1231 asset have likewise been rendered. Of these, the only ones of particular interest relate to properties built for rental and thereafter sold.

This problem was of particular interest because of restrictions on war housing erection. An early rule of thumb that rented units were Section 1231 assets, unrented ones held for sale, found little acceptance and later cases looked at the entire record of sales effort to determine whether the properties were actually investments or held for sale.[89]

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[84] *Raymond M. Hessert* (1947) par. 47,301, Prentice-Hall Memorandum T.C.

[85] *512 West 56th St. Corporation* v. *Commissioner* (2 Cir. 1945), 151 F. 2d 942, 34 AFTR 404; *Pekras*, footnote 83, above.

[86] *John D. Fackler*, footnote 80, above, *Pekras*, footnote 83, above. As to the effect of cancellation of a lease or distribution agreement for a consideration, see 1954 IRC § 1241.

[87] *Isadore Golonsky*, 16 T.C. 1450 (1951).

[88] A troublesome problem is occasioned by transfer in the form of leases with options to buy that provide that lease payments shall be credited on the purchase price. If the transaction is manifestly a sale, the payments are down payments on the purchase price, not rents. *A. B. Watson*, 24 B.T.A. 466 (1931), affirmed (9 Cir. 1933), 62 F. 2d 35, 11 AFTR 1051; *Robert A. Taft*, 27 B.T.A. 808 (1932). But if purchase is a real uncertainty the payments are not a true part of any sale price at the time made and therefore probably ordinary income to the lessor-seller. (See *Indian Creek Coal and Coke Co.*, 23 B.T.A. 950 (1931) for an analogous holding. See also Sternbach, "Lease Agreements Containing Options to Buy," *Taxes*, August 1948, Vol. 26, page 741.)

[89] *Delsing* v. *U.S.* (5 Cir. 1951), 186 Fed. 2d 59, 40 AFTR 25. *King* v. *Commissioner* (5 Cir. 1951), 189 F. 2d 122, 40 AFTR 665, cert. den., 342 U.S. 829; *Lucille McGah*, 15 T.C. 69 (1950); *Louis Rubino* (1944) par. 49,288 Prentice-Hall Memorandum T.C. Cf. *Elgin Bldg.*

When are patents held for sale? Formerly patents constituted a very troublesome segment of the "held for sale" problem. But the 1954 Code specifies that any sale (as opposed to simple licensing) of all or an undivided interest in all substantial rights under the patent, is the sale of a capital asset held more than six months. And it makes no difference if the purchase price is payable over the period of use of the patent by the purchaser, or is contingent upon the productivity or use of the patent rights.[90] It would seem that sales of patents will largely supplant licensing arrangements, under this favorable tax treatment.

This concludes discussion of the various asset categories and the considerations to be kept in mind by the seller in placing a value upon them for the purpose of sale. A few other questions remain, of more or less general importance.

8. Check List for Allocation

This article has so far undertaken to provide, in essence, a map of your general objectives in selling property, and guideposts to the possible roads to these objectives.

The following recapitulation should be helpful:

1. Allocate values realistically and logically.
2. Work out an allocation acceptable to the buyer.
3. Try to get
    (a) Long-term capital gains
    (b) A net gain or loss on Section 1231 assets with a minimum of offset.
4. Try to avoid
    (a) Ordinary gains
    (b) Short-term capital gains
    (c) Offsetting gains and losses on Section 1231 assets.
5. Value your inventories as close to cost as possible.
6. Be pessimistic as to what you can exclude from "property held primarily for sale to customers" and value such property in the same spirit.
7. Be prepared to defend your position that Section 1231 assets, except rental real estate, are actually used in a business and are not held for sale to customers.

9. Special Situations

"Fair market value" situations. A seller of property is occasionally confronted with the necessity of arriving at asset values, entirely apart from their economic worth to him or the allocation of a sale price as hereinbefore discussed. The determination of "fair market value" in such cases has special tax connotations and demands a far more rigid adherence to the general principles of asset valuation than is required in the allocation problem.

Valuation of property received. Frequently, a sale involves the receipt of property as part of the sale proceeds, in addition to cash. Unless this property is of the same kind and used in trade or business, it is considered to be realized gain or loss

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Corp. (1949), par. 49,015 Prentice-Hall Memorandum T.C.; *Rollingwood Corp.* (1950) par. 50,180 Prentice-Hall Memorandum T.C.

[90] 1954 IRC § 1235.

and your tax on any gain or your deduction of any loss is predicated upon ascertainment of its fair market value.

When you receive this sort of property in a sale, you must be prepared to support your opinion of fair market value of the property at that time, and all of the factors bearing upon such valuation should be fully investigated when you plan your sale, so that the tax exposure incident thereto can be estimated and guarded against. Beware of inflated values in your negotiations, unless you are willing to pay tax on gain in order to secure a high basis for depreciation. The allocation made in the course of the sale can be binding on you, so be sure it doesn't hurt you.

It is interesting to note that while ordinarily the value of property received is measured by the value of property transferred, sometimes this is not true.[91] Special circumstances, or different evaluations of pertinent valuation data might cause this result. But in general you will have the same interest as the buyer with respect to valuing the property he turned over to you in part payment.

Bargain sales. Another situation in which fair market value is of the greatest importance is where property is sold by a corporation to its controlling stockholders, at least if the corporation has earnings and profits for distribution. You are always likely to be accused of having sold the property for less than its fair market value, in such a case, and having paid a disguised dividend to the purchaser.[92] Before such a sale is made every effort should be exerted to obtain outside appraisals in a form and from persons who can support your sale price convincingly.[93]

Sales to related taxpayers. Even though bona fide and for adequate consideration, losses sustained on sales between related taxpayers are not deductible. This applies to sales between brothers, sisters, spouse, ancestors and lineal descendants.[94] This disallowance of loss also applies to sales between an individual and his controlled corporations, if either was a domestic or foreign personal holding company.[95]

Gains on such sales are nevertheless taxable. This is true even though unallowable losses occur in the same transaction.[96] There is even an added penalty where depreciable property is sold to a corporation controlled by the seller, any gain being ordinary income in spite of Sec. 1231.[97]

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[91] C. G. *Meaker Company, Inc.*, 16 T.C. 1348 (1951); in this case, under exceptional circumstances, a lease was held to be worth $81,000 while stock used to purchase it was found to be worth only $63,000.

[92] 1954 IRC § 301 et seq.; Reg. 118, Section 39.22(a)-1; *Timberlake* v. *Commissioner* (4 Cir. 1942), 132 F. 2d 259, 30 AFTR 583; *Palmer* v. *Commissioner*, 302 U.S. 63, 19 AFTR 1201 (1937). It was applied where only a part of the stockholders received the transfer, *Elizabeth F. Strake Trust*, 1 T.C. 1131 (1943), but this result is questionable under *Shunk* v. *Commissioner* (6 Cir. 1949), 173 F. 2d 747, 37 AFTR 1211, reversing 10 T.C. 293 (1948).

[93] See "Converting Income to Capital Gain," by Samuel Brodsky; "Selling an Entire Business," by Paul V. Wolfe; "Sales of Business Property," by Charles Gaa; "Who Should Sell—Corporation or Stockholder," by Jay Slonim.

[94] 1954 IRC § 267; 1939 IRC § 24(b).

[95] This is carried so far that a corporate loss was disallowed in a sale by which the purchaser lost control of the corporation, *Drake, Inc.* 3 T.C. 33 (1944), affirmed (10 Cir. 1944), 145 F. 2d 365, 32 AFTR 1475; and an individual was denied a loss on a sale by which he acquired control of the corporate purchaser, *Prentiss D. Moore*, 17 T.C. 1030 (1952) affirmed (5 Cir. 1953), 202 F. 2d 45.

[96] *Morris Investment Corporation* v. *Commissioner* (3 Cir. 1946), 156 F. 2d 748, 35 AFTR 32, cert. den. 329 U.S. 788. A detailed treatment of this technical subject will be found in "Sales Between Related Taxpayers," Seymour S. Mintz. Also see, "Transactions Between Controlled Groups," by Walter A. Cooper and Sydney Prerau.

Collapsible corporations. "Collapsible corporation" is a term brought into the revenue statutes in 1950, although used by tax men long before this. It is descriptive of that interesting (and formerly lucrative) device of a single corporation formed to build or manufacture property, and then to distribute it to its shareholders, or to permit them to sell their stock, the new owners liquidating the corporation and distributing the property. Either of these procedures resulted in the realization of capital gain to the shareholders, upon distribution of the property or sale of the stock, instead of corporate taxes, plus capital gains tax, or a tax on ordinary income realized by the parties.

Congress removed this tax device by amending the law in 1950 so that the distribution of the property of a collapsible corporation or the sale of its stock, results in ordinary income.[98] Various special provisions are contained in the law, the principal one being that three years after the completion of manufacture or construction, the corporation ceases to be collapsible and any gain thereafter realized on distribution or sale of stock is capital gain.

If you own stock in any company organized for a single-shot manufacturing or building operation, watch very carefully lest you come within this section and are tagged with tax on ordinary income on sale or distribution.[99]

Acreage. Occasionally your sale planning may anticipate an otherwise troublesome tax situation. A shining example of this lies in the types of property which may change in character from capital to non-capital assets, thus losing the special treatment afforded long-term capital gains. Foremost among this type of asset we find unimproved real estate, originally purchased for investment purposes and subsequently becoming more valuable for building sites or some other similar use. This sort of property is converted to "property held for sale to customers" (a non-capital category) by subdivision before sale, except under the restricted statutory provisions.[100] Sale of this property before subdivision may consequently result in a better tax position and net substantially more to the seller than subdivision and higher piece-meal sale prices.

Timber. Timber, standing or cut may be a capital asset, a non-capital asset or a Section 1231 asset, depending upon a variety of factors. In addition, the statute provides an election giving a different treatment from any of these. The sale of timber or timber land is extremely technical and you should familiarize yourself with the subject by consulting your tax adviser before making your sale plan.

Other special situations. There are, of course, a wide variety of other sale situations in which special tax considerations or provisions are applicable. These are for the most part of such specialized interest or such technical application that detailed discussion is deemed inappropriate in this article, and reference is accordingly made to the technical articles dealing with them.

Such situations include sales with lease-backs,[101] sales for annuities,[102] sales through subsidiaries,[103] sales of fiduciaries,[104] involuntary conversions,[105] sales of patents or copyrights,[106] disposition of certain types of mortgaged property,[107] sale of livestock and crops.[108]

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[97] 1954 IRC § 1239.

[98] 1954 IRC § 341.

[99] See "Collapsible Corporations, Organization and Operation," by Jay O. Kramer.

[100] 1954 IRC § 1237.

[101] See "Leasebacks," Miriam I. R. Eolis.

[102] See "Sales for an Annuity," by Milton H. Stern.

Where you have any of these, check your tax angles most carefully. There are often right and wrong ways of making sales of property covered by these articles which provide tremendous tax differentials.

Points to Remember:

1. Plan your sales of property as to
The time the sale is completed, and
The time payments are made.

2. Plan your sales to fit your business form, as a
Sole proprietor, or
Partnership, or
Corporation.

3. Make an allocation of your sale price between categories of assets sold, to realize, as far as possible, long term capital gains, or ordinary losses.

4. Make the allocation with the buyer's approval and as part of the sales contract.

5. Check the special situations discussed or referred to in the last section of the article to see if you have any tax problem requiring further and more technical study.

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[103] See "Sales Between Related Taxpayers," by Seymour S. Mintz, and "Transactions Between Controlled Groups," by Walter A. Cooper and Sydney Prerau.

[104] See "Sales by a Fiduciary," by Joseph Hawley Murphy.

[105] See "Involuntary Conversions," by Bernard H. Greisman.

[106] See "Patents and Copyrights," by William R. Woodward.

[107] See "Mortgages with Negative Bases," by Alvin D. Lurie, and "Mortgage Foreclosures and Settlements," by Charles A. Morehead.

[108] See "Livestock," by Harry M. Halstead, and "Unharvested Crops," by Byron Ver Ploeg.

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46

Writing Minutes

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A director's meeting might be described as a place where *hours* are wasted and *minutes* are preserved. Certainly corporate minutes have a very definite impact on taxation. They may furnish the taxpayer proof that an action is what it purports to be; contrariwise, the Commissioner of Internal Revenue may be able to show that a particular transaction *couldn't* have been what it was labelled. As contemporary witnesses, the minutes are in the position of a neutral expert whose testimony can be subpoenaed by either party; but the taxpayer, at least, can know what he would *like* the minutes to prove when he originally writes them up. At least the taxpayer may do so if he fully realizes how many tax cases are won or lost by what the minutes set forth.

1. Points to Consider

The minutes may have tax significance in such matters as

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2. Incorporation

The minutes may have tax significance at the very start of a corporation's life. Thus the individual incorporators may give their company assets in return (allegedly) for the stock and notes; but if a Revenue Agent reads in the minutes of the organization meeting that the assets in question had been transferred to the corporation solely in return for the stock, then the notes will not be deemed to have been a part of the transaction at all. Receipt of the notes may be taxed as a dividend, for the minutes indicated that these notes had not been given in return for assets.[1]

The minutes may help to determine whether the organization is actually a corporation. In appraising whether sufficient indicia of a corporate nature exist to justify the finding that a corporation existed, one of the factors to be considered is whether a minute book was maintained.[2]

When a stockholder advances money to his corporation, the question often arises as to whether this payment represents an investment of capital or a loan. If the corporate minutes do not indicate that a loan had been made and that a liability therefore exists, the Commissioner of Internal Revenue may be justified in considering that the payment was additional investment in stock.[3] Minutes could have spelled out the fact that the payment really was a loan, and the "borrowing" corporation could have obtained such tax advantages as deductions of interest on amounts paid to the lender and likewise borrowed capital credit for excess profits tax purposes. But the courts are not likely to recognize that a loan had been effected in the absence of evidence of any action taken by the directors of the "borrowing" corporation to assume liability on behalf of the "borrower" with respect to "loans" from the stockholder.[4] Minutes, however, could supply the necessary evidence as to the true nature of the advance.

Minutes may recite that a certain accounting period is adopted by a corporation, but this is not controlling if the books of account actually are kept on the basis of a different accounting period. Minutes may establish a presumption, but the *fact* can be determined by what was done, the intention never having been effectuated.[5]

3. Compensation

Corporate minutes play an important part in compensation matters. Frequently a corporation will authorize compensation in one year to make up for what had not or could not have been paid in an earlier year; and the question arises as to the taxable year in which the deduction may be taken. The corporation may claim the deduction in the year of authorization rather than in the year to which the payment applies, if no liability existed in the earlier year; and one of the most effective ways of establishing this is by reference to the minutes. If the resolution discloses no prior agreement or legal obligation to pay the compensation now being voted, the deduction will be allowed in the year when payment *is* approved.[6]

To justify increased compensation in one year, a corporation often claims that prior salaries were inadequate. But proof is necessary, and a resolution that increases compensation without reference to past inadequacies will be self-defeating.[7] Where the minutes fail to recognize that compensation was really for prior years, testimony long after the event may be deemed to be "not convincing."[8] The principles of the *Ox Fibre Brush Company* case could not be applied in the absence of any directors' meeting establishing salaries or showing a consideration of the salaries paid in former years and in the absence of record as to the manner of determination of salaries in those years or their treatment.[9] One corporation lost its alleged "past services" case because the minutes specifically declared that payment was for services rendered in the year of payment.[10]

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[1] *Joseph T. Coyle*, par. 50,022 Prentice-Hall Memorandum T.C. (1950).

[2] *Commissioner* v. *Rector and Davidson* (5 Cir. 1940), 111 F. 2d 332, 24 AFTR 919.

[3] *Powers Photo Engraving Co., Inc.*, 17 T.C. 393 (1951).

[4] *Cohen* v. *Commissioner* (2 Cir. 1945), 148 F. 2d 336, AFTR 939.

[5] *Iron Mountain Oil Company* v. *Alexander* (10 Cir. 1930), 37 F. 2d 231, 8 AFTR 9976.

[6] *Lucas* v. *Ox Fibre Brush Company*, 281 U.S. 115 8 AFTR 10901 (1930).

The minutes should show reasons for increasing or decreasing executive compensation, but these should be reasons of *individual* performance, or the Commissioner may believe that the fluctuating salaries are really non-deductible dividends. As an example of what to avoid, consider the minutes of one corporation, where authorizations of salary increases contained such phrases as "prospects for the coming year showed that the Company is able to pay an increase of salary," "after some discussion of the outlook for the coming year it was decided that the salaries of the officers . . . should be increased," and "the Company would experience much better times in the near future." When reductions were effected, the minutes had such notations as "Business has been so slack this year and indications are that it will not be better for some time to come," that reduced salaries were exclusively "due to business conditions," and that it was necessary "to make some reduction in salaries and wages in order that the Company maintain its present credit rating and good financial conditions." All of these frank admissions indicated that earnings of the corporation and not performance of the individuals determined the payments; and they were deemed to be non-deductible dividends rather than compensation.[11]

If a bonus is paid in a taxable year subsequent to the period to which it applied, deduction may still be taken in the earlier year if the minutes establish why payment was not made at that time. An acceptable reason would be that payment was deferred until approval had been obtained from the National War Labor Board.[12]

During various periods when wage controls existed, the Commissioner of Internal Revenue was authorized to disallow to the payor any deduction for compensation that had been increased without proper Governmental approval. One way of coping with this situation depends upon the wording of the resolution that increases the rate of compensation. If the resolution increases commission rates a specific percentage but makes no mention of how or under what circumstances the commissions are to be paid, the Commissioner may not claim that this is an increase in compensation without approval by (say) the Wage Stabilization Board. Since no provision for payment and accruals was made, the resolution must be regarded as a statement of future policy and not the creation of a liability. Without such a liability, the resolution could only indicate an existing intention on the part of the corporation to incur an obligation when wage controls no longer existed.[13]

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[7] *Glenshaw Glass Company, Inc.*, par. 46,245 Prentice-Hall Memorandum T.C. (1946).

[8] *Compeco Dye Works, Inc.*, par. 44,232, Prentice-Hall Memorandum T.C. (1944).

[9] *Outlet Clothing Co., Inc.*, par. 45,358 Prentice-Hall Memorandum T.C. (1945).

[10] *Wood Roadmixer Company*, 8 T.C. 247 (1947).

[11] *Builders Steel Company*, par. 49,069 Prentice-Hall Memorandum T.C. (1949).

[12] *Produce Reporter Company*, 18 T.C. 69 (1952).

Minutes may determine the year of deductibility of contingent salaries. Where a resolution at the start of a taxable year sets forth clearly what the compensation scale will be should sales attain a specified figure, the corporate liability is automatic if the conditions are fulfilled; and a formal authorization of payment in the subsequent year will not affect the deductibility of the amount in the earlier period.[14]

The minutes are useless if vague. If the directors vote a sum not to exceed a stated figure to be paid to officers as additional compensation for extraordinary services, but the time and actual amount of the payment are left to the discretion of the treasurer, the company may not claim a deduction in the year of the resolution, for liability is conditioned upon future events which may never occur.[15]

4. Gifts

A resolution may show that a so-called gift actually is in consideration for past services and hence is no gift. Resolutions in connection with gifts are frequently couched in flowery language that flatters the recipient but which clearly shows that there was no donative intent on the part of the corporation. Where the payor has thus established that the payment was in return for valued services, the recipient will find it virtually impossible to avoid paying income tax on his "gift." The expression of gratitude accompanying a so-called gift may be expressed in such appreciative words that taxability is virtually spelled out. Very damaging is a statement that an employee had "for many years rendered valuable services to the corporation at an inadequate salary," [16] or a declaration that a wedding check was given to an executive "in recognition of the very efficient manner in which he had for years 'handled the company's affairs.' " [17] A reputed gift can scarcely be treated as anything but compensation where the minutes recite that it is being made to an officer "in recognition of the faithful services rendered to the . . . Corporation . . . over a period of 26 years and for which services the compensation received by [him] has been entirely inadequate . . ." [18]

Yet minutes may indicate that the payment really was a gift. When the stock of a corporation was acquired by other interests, the bankers of the new interests indicated to the old president that it would be nice for all concerned if he resigned. He did so, whereupon the new directors resolved to present him with a check in appreciation of his excellent guidance of the corporation. In holding that this was a gift, the court noted that the minutes referred to "award" and "honorarium" and that payment clearly had been made without liability.[19]

Even though the minutes declare that a certain payment is a gift, that does not make it so. What was the intention of the directors, to reward services or to effectuate some donative intent? The wording of the resolution may answer this question. Although the minutes may refer to some form of economic benefit as "a gift from the company, and not as an extra compensation for services rendered," a court may conclude that the entire arrangement was really compensatory despite the language used.[20] But even if they are not conclusive, the minutes are the best place to find the real motivation for the payment.

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[13] *Woodlawn Park Cemetery Company*, 16 T.C. 1067 (1951).

[14] *Mobile Drug Company* v. *U.S.* (D.C., S.D. Ala. 1930), 39 F. 2d 940, 8 AFTR 10640.

[15] *E. B. & A. C. Whiting Co.*, 10 T.C. 102 (1948).

[16] *Taylor-Logan Company* v. *White* (1 Cir. 1933), 62 F. 2d 336, 11 AFTR 1295.

[17] *Nickelsburg* v. *Commissioner* (2 Cir. 1946), 154 F. 2d 70, 34 AFTR 1087.

[18] *Carragan* v. *Commissioner* (2 Cir. 1952), 197 F. 2d 246, par. 72,442 P.-H. 1952 Fed.

[19] *Cunningham* v. *Commissioner* (3 Cir. 1933), 67 F. 2d 205, 12 AFTR 1385.

5. Reasonableness of Salaries

When it comes to the question of whether the Commissioner may disallow any portion of compensation to the payor as unreasonable, the courts seem inclined to give presumptive acceptance to corporate minutes. The minutes create an inference that salary allowances are reasonable if the resolution is passed in good faith.[21] The action of the board of directors under ordinary circumstances in fixing the salaries raises a fair presumption of reasonableness.[22]

6. Economic Benefits to Employees

The minutes may determine whether other financial arrangements are intended as compensation to employees. If an economic benefit (such as the payment of an officer's life insurance premiums) is meant to be compensation, the minutes should so indicate, for in the absence of such a notation, the amount may be disallowed to the corporation on the theory that the company was merely acting as an agent for the officer.[23] The assumption of personal income taxes of its officers by a corporation may be regarded as additional taxable compensation; certainly that will be the case if the terms of the resolution indicate that the corporate action was in recognition of services performed by the executives.[24] The minutes may establish that a payment is not compensation but reimbursement of expenses and hence not taxable, as where the Commissioner's claim that an officer had received additional income was refuted by the following resolution: "RESOLVED, that the corporation reimburse the Vice President in Charge of RCA Laboratories in the amount of $14,664.20 for the loss caused to him by the sale of his former home in Bronxville, N.Y., in complying with instructions of the President to move his residence to the vicinity of the RCA Laboratories at Princeton, N.J." [25]

The most important reason why any stock option to an employee is apt to be considered by the Commissioner to be taxable income for services is that in the *Smith* case, the Supreme Court so held. The apparent seal of approval was thus placed on all employee stock option situations because in that case the minutes recited the fact that an officer was given the option to buy stock "in consideration of his services theretofore rendered . . ." [26] Yet a corporation may choose to give an option to a certain employee for other reasons: for example, as incentive to do a better job in the *future* rather than as compensation for the *past*. Or the option may be given as a form of payment for assets that the employee gave to the corporation. But unless the minutes are very clear as to why the employee is given his option, the Commissioner will surely claim that compensation was the intention and purpose.

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[20] *Levey* v. *Helvering* (C.A., D.C., 1933), 68 F. 2d 401, 13 AFTR 517.

[21] *Toledo Grain & Milling Co.* v. *Commissioner* (6 Cir. 1932), 62 F. 2d 171, 11 AFTR 1073.

[22] *William S. Gray & Company* v. *U.S.* (Ct. Cls. 1929), 35 F. 2d 968, 8 AFTR 9798. *Benz Bros. Co.*, 20 B.T.A. 1214 (1931).

[23] *Hubert Transfer & Storage Company*, par. 48,043 Prentice-Hall Memorandum T.C. (1948).

[24] *Old Colony Trust Company, et al.* v. *Commissioner*, 284 U.S. 552, 10 AFTR 786 (1932).

[25] *Otto Sorg Schairer*, 9 T.C. 549 (1947).

[26] *Commissioner* v. *Smith*, 324 U.S. 177, 33 AFTR 581 (1945).

7. Timeliness of Payments

According to the Internal Revenue Code,[27] a corporation may take no deduction for unpaid expenses (such as salaries) that are not paid within two and a half months after the close of the taxable year, if the potential payee owns more than 50 per cent of the corporate stock. The question of *constructive payment* comes up; and the minutes may be decisive in establishing whether the payee received what was equivalent to payment within the statutory period. Thus if the minutes award specific amounts to named persons, placing the amounts to their credit subject to payment upon demand, constructive payment has taken place even if actual payment is not made until a subsequent taxable year.[28] Even though the minutes recite that a stockholder-employee is to be paid a specific sum and the amount is accrued on the books, that is no proof of an allowable deduction, for the corporation may not have had sufficient funds to constitute a constructive payment.[29] And even if a corporation *does* have sufficient funds, deduction will not be permitted if the accrued amounts are not in some way identified or earmarked; the minutes are an ideal place for a contemporary record of corporate action.[30]

In the case of bonuses, it is particularly important that the resolution be spread on the minutes early in the year. If bonuses are not authorized by the board of directors until the last month of the taxable year, the court is not likely to agree that these bonuses had been informally granted at the beginning of the year, especially where the minutes of the meeting at which they *were* granted stated that the resolution was passed because "the accountant had requested that the board of directors adopt the resolution." The "bonuses" may be treated as dividends in such a situation, if the officers are also stockholders.[31]

Minutes may be used to ascertain the time of deduction of charitable contributions. Accrual-basis corporations have the option of deducting a contribution paid within 75 days of the close of its fiscal year in either the year of authorization by its board of directors or the year of payment.[32] If the contribution is authorized on or after January 1, 1953, there must be attached to the corporation's income tax return a copy of the resolution of the board of directors authorizing the payment.[33]

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[27] 1954 IRC § 267(a)(2)(A); 1939 IRC § 24(c).

[28] *Michael Flynn Manufacturing Company*, 3 T.C. 932 (1944).

[29] *H & H Drilling Co., Inc.*, 15 T.C. 961 (1950).

[30] *Van W. Peabody, et al.*, 5 T.C. 426 (1945).

[31] *Sarfert Hosiery Mills, Inc.*, par. 47,306 Prentice-Hall Memorandum T.C. (1947).

[32] 1954 IRC § 170(a)(1)(2); 1939 IRC § 23(q).

[33] T.D. 5979, 1953-1 CB 55.

8. Pensions

Corporate minutes in themselves do not create pension liability and hence the basis for an allowable deduction. If a board of directors resolves to establish a pension fund for the benefit of employees "in substantial compliance with the terms and provisions of the Trust Instrument hereto attached and made a part of this resolution," no deduction will be allowed if the trust agreement actually is not executed until the following taxable year.[34] But if the directors appropriate funds for a pension plan that is ordered to be set up, a deduction will be permitted even though the trust itself is not created until the following taxable year, for the money would have been set aside and directors' intentions would have been made apparent from the minutes.[35]

Payment of an alleged pension to the widow of a deceased employee may be disallowed, if there is no evidence in the minutes or elsewhere that the corporation has a pension plan or previously had paid pensions to retired employees who actually had rendered services.[36] Nor will such a pension deduction be allowed to a corporation, if the minutes indicate that the *real* reason for the payment is not the company's liability. In one such case, the Commissioner successfully showed from the corporation's minutes that the "pension" had been voted "in consequence of . . . The fact that dividends had not been paid by the Company on its stock during the past four years . . . [and the widow] has been left with practically no income." [37] Such a resolution is fatal because it emphasizes the need of a recipient rather than a corporate obligation.

9. Tax on Unreasonable Accumulation of Surplus

For the purpose of the tax on unreasonable accumulation of surplus,[38] minutes play a very important role. Since the surtax is imposed upon any corporation accumulating surplus beyond the reasonable needs of the business, the minutes certainly present an excellent means of establishing contemporary reasons for having to retain earnings. That is so regardless of whether the burden of proof rests in the first instance upon taxpayer or Commissioner. The words of the Board of Tax Appeals on this subject can scarcely be bettered: "The testimony concerning the purpose for which the corporation was formed and the purpose for which its surplus was accumulated is corroborated by the minutes of the meetings of the directors of the company—the contemporaneous record reflecting the company's activities and the reasons therefor. We are not ready to disregard this testimony or say that the recorded thoughts of the company's guiding heads, the writing of which was begun more than a decade ago, was artfully drawn for self-service against the future day of trial. Those denials of wrongful intent, those declarations of a purpose other than the avoidance of taxes in the building of a surplus, we believe, as against the evidence of circumstances from which might be drawn inferences to opposite effect." [39] In the first published book on the subject, the authors have given this counsel: "Have a written plan as to the *purpose* underlying the retention. The corporate minutes would be a good place for this plan, for it must be of unquestioned contemporary authenticity." [40]

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[34] *Abingdon Potteries, Inc.*, 19 T.C. 23 (1952).

[35] *Crow-Burlingame Company*, 15 T.C. 738 (1950).

[36] *W. D. Haden Company*, par. 46,089 Prentice-Hall Memorandum T.C. (1946).

[37] *McLaughlin Gormley King Company*, 11 T.C. 569 (1948).

[38] 1954 IRC § 531; 1939 IRC § 102.

Retention of earnings may be justified for such purposes as need for expansion, modernization, working capital, and the like; but testimony of an officer as to why dividends were not paid several years ago may seem self-serving *after* a Revenue Agent has made his report. But minutes of directors' meetings during the taxable year will tend to prove why earnings really were withheld.[41] If the directors anticipate a post-war increase in inventories and accounts receivable, retention of earnings is justifiable; but there must be proof (as in the form of minutes) that Management really anticipated such a development during the taxable year.[42] A reserve for renegotiation is justification for retention of earnings where this potential liability may be demonstrated (*via* the minutes) to have been a factor taken into account by the directors when the advisability of declaring dividends was under consideration.[43]

Cases shortly before the passage of the Internal Revenue Code of 1954 indicated that retention of earnings was not justified in a situation where a plan could not be effectuated in the predictably near future, for such reasons as building restrictions, lack of priorities, or shortages.[44] The new law sought to take the edge from this so-called "immediacy test." [45] Yet the corporation still has the responsibility of protecting itself, as the added italics indicate: "In any case *where there exists a definite plan* for the investment of earnings and profits, such corporation need not necessarily consummate these plans in a relatively short period after the close of the taxable year. However, where the future needs of the business are uncertain or vague, or *the plans for the future use* of the accumlations are indefinite, the amendment does not prevent application of the accumulated earnings tax." [46]

10. "Who Makes the Sale?"

Minutes may be important in ascertaining the taxpayer in the type of transaction known as "Who Makes the Sale?" This refers to a situation where stockholders make sales of assets originally owned by a corporation, after a liquidating dividend or a distribution in kind; and the question is whether the corporation is to be taxed upon the sale of the assets or whether the stockholders will be taxed. If a corporation adopts a plan of complete liquidation and within the next twelve months the corporation disposes of all of its assets (less assets retained to meet claims) in complete liquidation, then no gain or loss will be recognized to the corporation.[47] Where the corporation declares and pays out a distribution in assets to its shareholders, who upon their own responsibility dispose of the assets thus assigned, a gain from this sale may result in elimination of a double tax: that is, the corporation will not be taxed while a secondary tax is then imposed upon the stockholders when they receive their shares of the profits as dividends. The vital questions are: did the corporation liquidate before the stockholder sale? Did the corporation participate in the negotiations that resulted in the ultimate sale? If the answer is Yes, the double tax threat exists. Thus the question is one of timing and of proof: who conducted the negotiations? Who owned the assets at the time? With whom was the ultimate buyer dealing, the corporation or the stockholders? The minutes may supply the key to these answers.

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[39] *Cecil B. DeMille Productions, Inc.,* 31 B.T.A. 1161 (1935).

[40] J. K. Lasser and Robert S. Holzman, *Corporate Accumulations and Section 102.* Albany: Matthew Bender & Company, Incorporated, 1949. Page 135.

[41] *Shaw & Keeter Motor Company,* par. 51,235 Prentice-Hall Memorandum T.C. (1951).

[42] *Lannom Manufacturing Company, Inc.,* par. 52,043 Prentice-Hall Memorandum T.C. (1952).

[43] *Eastern Machinery Company,* par. 51,321 Prentice-Hall Memorandum T.C. (1951).

[44] *Colonial Amusement Corporation,* par. 48,149 Prentice-Hall Memorandum T.C. (1948); *Twin City Theatres,* par. 52,133 Prentice-Hall Memorandum T.C. (1952); *E. L. Bride, et al.,* par. 53,345 Prentice-Hall Memorandum T.C. (1953); *World Publishing Company* v. *U.S.* (10 Cir. 1948), 169 F. 2d 186, 37 AFTR 150.

[45] IRC § 537.

[46] *Report of the Senate Finance Committee to Accompany H.R. 8300, 83d Congress, 2d* Session, Report #1622. Page 318.

Thus if the minutes do not indicate that the corporation was involved in any negotiations prior to the sale that is effected by the shareholders, gain may not be imputed to the corporation.[48] Minutes may reveal that it was the intention from the start to liquidate the corporation so that the assets would belong to the stockholders before the annual buying season.[49] But if the minute book is silent as to any intention of the corporation to distribute assets to its shareholders prior to a sale by the stockholders, the corporation will be taxed.[50] In one case, the corporation was able to avoid tax because the Court accepted the following entry in the minute books as evidence: "Further RESOLVED, that it is the intention of the company and of the Board of Directors in the declaration of the foregoing dividends, that such dividends irrevocably belong to the stockholders of record at the close of business on October 12, 1943, that the company by action of its Board of Directors in this connection, has divested itself of all title to the [property] necessary to carry such distributions in kind into effect, and it is hereby directed that all necessary entries on the books of this company be made accordingly, so as to separate such dividends from the corporate assets of the company." [51]

If the minutes are so carelessly prepared that the court cannot ascertain whether the assets were assigned to the stockholders before or after the sale was effected, the Commissioner's finding that the corporation was the seller will be deemed presumptively correct.[52] The minutes will not help a corporation in this respect if other actions indicate that the minute books are erroneous: for example, dissolution of the corporation may have been authorized prior to the sale of assets by the stockholders but nothing whatsoever had been done to effectuate this intention.[53] Deviation between the minutes and what actually took place *might* help the corporation instead of the Commissioner,[54] but that is a long gamble to take and certainly cannot be recommended.

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[47] IRC § 337. But if the statute is not fully complied with, the corporation may be taxed as if liquidation had not preceded sale. *Commissioner* v. *Court Holding Company*, 324 U.S. 331, 33 AFTR 593 (1946).

[48] *Doyle Hosiery Corporation*, 17 T.C. 641 (1951).

[49] *Burley Tobacco Warehouses, Inc.* v. *Glenn* (D.C., W.D. Ky. 1952), 106 F. Supp. 949, 42 AFTR 582.

[50] *H. B. Snively, et al.*, 19 T.C. 850 (1953).

[51] *Ripy Bros. Distillers, Inc.*, 11 T.C. 326 (1948).

[52] *Wichita Terminal Elevator Company* v. *Commissioner* (10 Cir. 1947), 162 F. 2d 513, 35 AFTR 1487.

The date of liquidation as contained in the minutes may not be controlling under the laws of some states. Thus in Washington, voluntary proceedings for dissolution require the designation of a trustee, but his appointment is not operative until copies of the resolution of liquidation are filed with the Secretary of State and with the County Auditor. Hence one corporation could not avoid tax on a sale of assets made by its chief stockholder prior to the date of the filing of the resolution, for under state law the assets were still the corporation's at the time of the sale to the buyer.[55]

11. Corporate Reorganizations

Reorganizations are regarded suspiciously by many persons (particularly the Commissioner of Internal Revenue) because they are so often an avenue of tax evasion rather than being an undertaking "for reasons germane to the continuance of the business of a corporation a party to the reorganization." [56] Accordingly, one of the purposes of the corporate minutes is the contemporary establishment of a sound business purpose for the reorganization. Where the Commissioner claimed that a purported reorganization was defective because lacking in sound business purpose, the court ruled against him because of this testimony: "We felt in our meetings that it was certainly the wise thing to do to simplify our corporate structure, eliminate the intercompany obligations, and unify our situation and our control over the management." [57] With such a notation in the minute book, sound business purpose could be readily proven. One of the most difficult types of reorganization to justify is the recapitalization from preferred stock (dividends on which are not deductible) to debentures (interest on which is deductible), but a reference in the minutes as to how the corporation would be benefited by such an exchange may be sufficient to prove the point to the satisfaction of a court.[58]

Requisite for a tax-free reorganization is a plan of reorganization, and lack of a plan will forfeit the exemptions sought.[59] There is no particular form that the plan of reorganization must take, but the minutes would be a very suitable place to record the plan. In one reorganization that was effected so that a new company could succeed to the activities of an old one, the court approvingly noted that the minutes authorized the new corporation "to begin business and carry on a business similar in nature to that carried on by the old company";[60] this unbroken continuity indicated that a true reorganization had been effected.

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[53] *Jones* v. *Grinnell* (10 Cir. 1950), 179 F. 2d 873, 38 AFTR 1364.

[54] *Oahu Beach and Country Homes, Limited,* 17 T.C. 1472 (1952).

[55] *E. D. Gensinger,* 18 T.C. 122 (1952).

[56] Reg. 118, § 39.112(g)-2. New regulations are yet to be issued.

[57] *H. G. Manning Trust Company, et al.,* 15 T.C. 930 (1950).

[58] *Penfield* v. *Davis* (D.C. Ala. 1952), 105 F. Supp. 292, 42 AFTR 115.

[59] *Peeler Hardware Co.,* 5 T.C. 518 (1945). *Kettler* v. *Commissioner* (7 Cir. 1952), 196 F. 2d 822, 41 AFTR 1342.

[60] *U.S.* v. *The Arcade Company* (6 Cir. 1953), 203 F. 2d 230, 1953 P.-H. par. 72,445.

Although it is not necessary that a plan of reorganization be incorporated into the minutes,[61] for certain types of reorganization there must be submitted copies of the minutes. Thus in connection with exemptions from gain or loss on assets disposed of by order of the Securities & Exchange Commission there is a requirement that a certified copy of the corporate resolution authorizing the exchange be attached to the income tax return.[62]

In the case of an involuntary conversion, the minutes may be useful in establishing that the proceeds of the facility which has been lost, destroyed, or seized are being "expended in the acquisition of other property similar or related in service or use to the property so converted . . ." [63] In holding against a corporation that there had been no involuntary conversion of containers, after a deposit account had been transferred to a miscellaneous income account, the court noted that the minutes had contained no provision or direction for placing the forfeited deposits in a special account to be used for any specific purpose.[64] If the stock of a company owning replacement assets is acquired, as is permitted by the statute, care must be taken *not* to suggest in the minutes of the acquiring company that the acquired company is to be dissolved immediately. There is authority for the Commissioner's holding that where stock is acquired solely to get assets upon an immediate liquidation, the cost of the stock shall be the basis of the acquired assets; fatal to the corporation was the fact that its minutes declared that the only intention it ever had in the purchase of stock was the acquisition of assets.[65]

12. Dividends

As to the payment of dividends in general, it is not necessary, for tax purposes, that there be any record in the minutes, for a distribution will be taxed as a dividend if the facts indicate that it is one, regardless of formalities.[66] It is not material that no formal resolution to liquidate or dissolve the corporation had been adopted when the distribution is made.[67] The adoption or failure to adopt a resolution of dissolution or liquidation is not controlling or determinative.[68]

When a stock dividend is involved, there should be a declaration spread in the minutes; failure to provide a reason for the issuance of the stock dividend is particularly unfortunate should the shares later be redeemed, for in the absence of a convincing contemporary reason, the court will accept the Commissioner's presumption that the redemption is a dividend.[69] Failure of the record in such a situation is likely to result in the court's own interpretation of the action, which is not likely to be in the taxpayer's favor. If there is no record of a resolution of the directors authorizing a stock dividend, the court may conclude that no such dividend ever was declared.[70]

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[61] *William H. Redfield,* 34 B.T.A. 967 (1936).

[62] Reg. 118, § 39.371-10. New regulations have not yet been issued, but § 1081 of the 1954 Code is similar to § 371 of the old.

[63] 1954 IRC § 1033; 1939 IRC § 112(f).

[64] *Nehi Beverage Company,* 16 T.C. 1114 (1951).

[65] *Kimbell-Diamond Milling Co.* v. *Commissioner* (5 Cir. 1951), 187 F. 2d 718, 40 AFTR 328. This principle has been incorporated into § 334 of the new Code.

[66] *Beretta* v. *Commissioner* (5 Cir. 1944), 141 F. 2d 452, 32 AFTR 418.

[67] *Kennemer* v. *Commissioner* (5 Cir. 1938), 96 F. 2d 177, 21 AFTR 103.

[68] *Horn and Hardart Baking Company* v. *U.S.* (D.C. E.D. Pa. 1940), 34 F. Supp. 89, 25 AFTR 786.

[69] *De Nobili Cigar Co.* v. *Commissioner* (2 Cir. 1944), 143 F. 2d 436, 32 AFTR 989.

Insofar as a "distribution essentially equivalent to the distribution of a taxable dividend" is concerned, no proof of the action of the board of directors is necessary, for such a "quasi dividend" will be taxed if it has the effect of a dividend regardless of *what* the transaction really is. If a distribution is in the nature of a dividend, it will be so taxed.[71] Whether a redemption is taxable as a dividend at ordinary rates or as a sale at capital gains rates is dependent upon a factual inquiry;[72] thus the minutes may be helpful or damning, according to the circumstances.

A reduction in the capital of a corporation may be deemed to be a dividend if the resolution under which the distribution is made makes no provision for cancellation or redemption of any stock.[73] On the other hand, where a corporation purchases some of its own stock for redemption but through oversight the shares are not cancelled, the transaction may be treated as a redemption provided that the resolution expressly provided that the stock be purchased and "retired upon the delivery thereof." [74]

If a corporation declares a dividend in kind to its shareholders, payable in assets that have appreciated in value since the company acquired them, the Commissioner may claim that the corporation must be taxed upon the profit arising from the sale of assets to an ultimate buyer. The corporation may avoid this tax if proof can be furnished (as in the minutes) that the intent of the directors was to declare a dividend in kind and not in dollars.[75]

Wherever a corporation tries to pass along appreciated-value assets to the stockholders, the Commissioner may try to involve the corporation; hence it is necessary to establish that the corporation actually parted with the assets before the sale, with the result that no part of the realized profit was the corporation's.[76]

The character of what a stockholder receives as a distribution is to be determined by the action taken by the directors to a large extent. Thus the language of the resolution is important in ascertaining whether a corporation distributed specific corporate assets or merely made a payment out of undivided profits.[77] A resolution calling for a distribution of assets rather than an amount of money will be deemed to be a declaration of a distribution in kind.[78]

Where there is a distribution in partial liquidation, minutes are extremely important in establishing what was done and *why*. In one case, a corporation could not argue that a redemption in par value of its stock was a distribution in partial liquidation, for the minutes stated that "our competitive position next spring will be good and we are anticipating an increase in volume." Such an optimistic statement indicates quite clearly that a partial liquidation was not considered or contemplated at the time.[79]

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[70] *Lester Lumber Company, et al.*, 14 T.C. 255 (1950).

[71] *Commissioner* v. *Van Vorst* (9 Cir. 1932), 59 F. 2d 677, 11 AFTR 562.

[72] *Report of the Senate Finance Committee To Accompany* H.R. 8300, 83d Congress, 2d Session, Report #1622. Page 233.

[73] *Wilcox* v. *Commissioner* (9 Cir. 1943), 137 F. 2d 136, 31 AFTR 358.

[74] *Samuel A. Upham*, 4 T.C. 1120 (1947).

[75] *General Utilities and Operating Company* v. *Helvering*, 296 U.S. 200, 16 AFTR 1126 (1935).

[76] *Reed Bros.*, par. 42,207 Prentice-Hall Memorandum B.T.A. (1942).

[77] *Joseph P. and Ruth B. Schmitt*, 20 T.C., No. 44 (1953).

[78] *Zalk-Josephs Company*, par. 51,215 Prentice-Hall Memorandum T.C. (1951).

If a liquidation is long drawn out, the Commissioner may claim that certain distributions are taxable dividends, as apparently there was really no intention of winding up the corporation. But the directors may let the matter drag out as long as they desire if they had been provided in the first place with a resolution calling for the disposition of assets "at such time and in such manner as in their best judgment could be deemed to be for the best interest of the stockholders." [80]

Minutes as to the date of a liquidation are not conclusive and may be refuted by other evidence.[81] It is difficult to argue that a liquidation took place at a particular time if the minutes are silent on that point. The absence of records in harmony with the statutory requirements would indicate that no bona fide plan of liquidation existed.[82] The minutes have an important role in effecting compliance with the statutory requirements as to liquidation. A notice of contemplated dissolution must be filed "within thirty days after the adoption by the corporation of a resolution or plan for the dissolution of the corporation or the liquidation of the whole or any part of its capital stock . . ." The necessary information returns must set forth "the terms of such resolution or plan . . ." [83]

13. Arm's Length Transactions

Minutes may be important in order to refute the Commissioner's contention that two or more companies are dealing at less than arm's length and that they do not really enjoy separate taxable existences.[84] The very fact that separate minute books are maintained by the several companies is an indication that they are actually separate entities.[85] Far more significant is the fact that sound business purposes may exist for carrying on an enterprise through the mechanism of several distinct companies. Thus in one case where it was held that the Commissioner could not re-allocate the earnings of one affiliate to another, the court pointed out that there were sound business reasons for having separate enterprises; and as authority for this finding the minutes of two directors' meetings were extensively quoted to show *why* a corporate business should be separated into several operating parts.[86]

14. Transactions to Avoid Taxes

The Commissioner may refuse to recognize the tax consequences of any transaction made primarily to evade or to avoid income or excess profits taxes.[87] A corporation that operated wholesale houses in five communities effected a reorganization by which each of these houses became a separate corporation. The Commissioner attempted to disallow the specific excess profits tax exemptions to the new companies on the ground that the reorganization had been effected for tax avoidance purposes, but the court sustained the taxpayer when it produced its minutes for the meeting at which the move was voted upon. Four separate business reasons were itemized for creating separate companies, and these purposes or objectives refuted the Commissioner's presumption that the reorganization was really motivated by tax considerations.[88]

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[79] *A. J. Long, Jr.*, 5 T.C. 327 (1945).

[80] *Bynum v. Commissioner* (5 Cir. 1940), 113 F. 2d 1, 25 AFTR 314.

[81] *National Grocery Company* v. *Commissioner* (9 Cir. 1940), 111 F. 2d 328, 24 AFTR 915.

[82] *Joseph F. Porter, Jr. et al.*, 9 T.C. 556 (1947).

[83] 1954 IRC § 6043; 1939 IRC § 148(d).

[84] 1954 IRC § 482; 1939 IRC § 45.

[85] *Brost Motors, Inc.*, par. 48,226 Prentice-Hall Memorandum T.C. (1948).

[86] *Barq's Bottling Company*, par. 46,150 Prentice-Hall Memorandum T.C. (1946).

[87] 1954 IRC § 269; 1939 IRC § 129.

If a corporation acquires another company that has unused losses or credits, the Commissioner may seek to disallow the acquirer any tax benefit arising from the transaction on the ground that the acquisition was primarily for tax avoidance purposes. The best way to refute this contention is to show why the acquisition was really effected; if sound business purposes may be shown, the statute does not govern the situation.[89] The minute books are an excellent place to show business reasons why the acquisition took place.

15. Other Uses of the Minutes

Minutes may be decisive in settling where title passed, at least to the extent of indicating where it was the seller's intention to vest title.[90] Abandonment of equipment was deemed to have been prompted by the desire to save operating expenses rather than the existence of obsolescence in one case where the court felt that the absence of any reference to obsolescence in the minutes of the meeting that authorized the write-off was significant.[91] A corporation could not refute the Commissioner's presumption as to the number of original units among which cost basis was to be allocated, for the minutes were silent on this point.[92] Where a corporation issued bonds to replace other securities on which it had agreed to assume obligations, it was held that similar assumption on the new issue could not be presumed in the absence of any notation in the minutes to that effect.[93]

The minutes may be the arbiters in almost any situation where it is necessary to determine the intent of the corporate officers or the chronology of events. There are many instances of tax liability being determined by the taxpayer's motives, and intent may be proven or disproven by contemporary records. Thus the minutes can be used as evidence in such matters as "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," [94] or ascertaining whether a transaction was one "in carrying on any trade or business," [95] or whether amounts were paid "to increase the value of any property or estate," [96] or whether property was purchased with the intention of razing an existing structure for replacement with a new one.[97]

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[88] *Alcorn Wholesale Company, et al.*, 16 T.C. 75 (1950).

[89] *Alprosa Watch Corp.*, 11 T.C. 240 (1948).

[90] *Buckeye Engine Company*, 11 B.T.A. 318 (1928).

[91] *The S.S. White Dental Manufacturing Company* v. *U.S.* (Ct. Cls. 1941), 38 F. Supp. 301, 26 AFTR 1094.

[92] *Winifrede Land Company*, par. 53,088 Prentice-Hall Memorandum T.C. (1953).

[93] *Sharon Herald Company* v. *Granger* (3 Cir. 1952), 195 F. 2d 890, 41 AFTR 1136.

[94] 1954 IRC § 1221(1); 1939 IRC § 117(a)(1).

[95] IRC § 162(a).

16. Minutes As Evidence

Minutes may be accepted as evidence in any Federal tax action.[98]

Ordinarily corporate officers will be estopped to deny the validity of any minutes that they certify.[99]

The treasurer of a corporation is not privileged to withhold the corporate books on the grounds that their contents might criminate the corporation.[100]

17. Conclusion

Since the corporate official who is charged with the writing up of the minutes usually is not the company's tax advisor, it is a very wise step to have tax counsel review the minutes from his specialized point of view before the language is finalized. Certainly no one would suggest that the minutes be falsified—there are worse penalties in life than the paying of tax deficiencies. But the minutes can and should be drawn to show the desired intent and purpose, to eliminate false impressions, to effectuate what really took place. Indeed, the corporate secretary could use as his golden text these words: ". . . and another book was opened . . . and [they] were judged out of those things which were written in the books . . ." [101]

Bibliography

For examples of minutes for the purposes described above, see:

Doris, Lillian, and Edith J. Freedman, *Corporate Meetings, Minutes, and Resolutions.* New York: Prentice-Hall, Inc., 1944.

Pellard, Alfred S., *Lawyers' Tax Manual.* New York: Clark Boardman Company, Ltd., 1949.

Rabkin, Jacob and Mark H. Johnson, *Current Legal Forms With Tax Analysis.* Albany: Matthew Bender & Company, Incorporated, 1948, 3 vols.

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[96] IRC § 263 (a)(1).

[97] *Ingle* v. *Gage* (D.C. W.D. N.Y. 1931), 52 F. 2d 738, 10 AFTR 480.

[98] Title 28, U.S. Code § 1732.

[99] *Corpus Juris Secundum.* Brooklyn: The American Book Company, 1939. XVIII, 612.

[100] *State* v. *Henkel,* 201 U.S. 43 (1906).

[101] Revelations 20:12.

Part VI

DIVIDENDS AND OTHER RELATIONS WITH STOCKHOLDERS

47

The Penalty Tax on Accumulated Earnings

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1. Points to Consider

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The tax on corporations improperly accumulating surplus, formerly known as Section 102 and now renumbered as Sections 531 to 537, has been so feared and vilified that most businessmen have always tended to take it too seriously. Certainly, the amendments under the Internal Revenue Code of 1954 should allay some of the worry of the past. The relatively small company is henceforward exempt, for in no case will the tax be imposed on any corporation which has not accumulated earnings to the extent of $60,000.[1] Yet it cannot be casually dismissed by the managements of substantial and profitable closely-held companies. For them the tax penalty is still an element in the decision as to whether yearly income is to be retained or distributed as dividends. A systematic approach toward this policy decision involves understanding the place of Section 531-7 in the tax structure, appraising how it has been administered thus far, and, finally, hazarding some prediction concerning its administration in the light of past history and the 1954 changes.

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[1] 1954 IRC § 535(c)(2).

2. The Statute

The provisions of Sections 531-7 impose a surtax upon net income (after income taxes accrued, dividends distributed, capital gains,[2] and certain new credits provided by the 1954 Act) if the corporation is formed or availed of for the purpose of preventing the imposition of the surtax upon its individual shareholders.[3] The initial rate of the surtax is 27½ per cent, with an increase to 38½ per cent beyond $100,000. It is a surtax upon annual profits, not upon the amount of surplus accumulated on the books during preceding years.

Three major changes in the 1954 Code have reduced the scope of the tax. As earlier noted, there is a minimum credit which is allowable to the extent that $60,000 exceeds the total accumulated earnings and profits at the close of the preceding year. A second credit, provided for the first time, consists of an amount equal to that part of the profits retained for the reasonable needs of the business.[4] In the past, if the penalty tax was imposed at all, it fell upon all the profits retained by the company during the year, regardless of the fact that some portion of the accumulation could be justified. According to the Senate Committee,[5] it was this aspect of the tax which taxpayers found generally alarming, for while they may feel confident that they can justify the accumulation of most of their earnings, they may feel less certain about a minor portion of their accumulations and fear that this will subject their entire accumulated earnings to tax. Finally, for the benefit of concerns which at the end of the fiscal year are unable to compute their income and decide upon the amounts to be kept or distributed to the stockholders, the deduction for dividends paid has been extended to include distributions made within two and a half months subsequently.[6] Thus a calendar year taxpayer has an additional period of grace until March 15.

The main thrust of the statute lies in Section 533(a) which provides that "the fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the preponderance of evidence shall prove to the contrary." (Until the 1954 Act the requirement was "by the *clear* preponderance" of the evidence, so that a further change in proof has been made in the taxpayers' favor.) Nearly all current cases deal with the question of whether profits have been retained beyond reasonable limits. In the typical situation involving a closely-held company, especially a one-man or several-man concern, a holding that retained earnings exceed the requirements of the business would be enough to demonstrate the shareholders' purpose.

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[2] § 315(a) of the Revenue Act of 1951 added subparagraph D to Section 102(d)(1). The general effect of the amendment is to provide for the deduction of net capital gains in computing the Section 102 net income subject to the penalty tax.

[3] 1939 IRC § 102(a), § 531 of 1954 IRC.

[4] 1954 IRC § 535(c)(1).

[5] Senate Finance Committee, Report No. 1622, 83d Cong. 2d Sess., dated June 18, 1954 (hereafter referred to as "Senate Report"), p. 72.

[6] 1954 IRC § 563(a).

Several recent district court cases,[7] however, have emphasized that despite a finding of an accumulation beyond the reasonable needs of the taxpayer, there should be a second and independent finding that the earnings were withheld with the intent of enabling the shareholder to escape the surtax. Under these circumstances, any company against which the penalty tax has been asserted would be well advised to offer proof to meet the possibility of either finding.

3. The Purpose of the Statute

Despite complaints frequently levelled against it, Section 531-7 has a legitimate function in the tax structure. Closely-held operating companies, as well as investment companies, may be used to avoid surtaxes upon stockholders. Some concerns expand to retain as well as retain to expand—and the Internal Revenue Service is powerless against them. Further, even before the tax was softened by the 1954 amendments, some companies were being advised to withhold dividends consciously because surtax rates on individuals made it cheaper to take a chance and even pay the Section 102 tax if it should be imposed.[8] No one really denies the need for some statute as long as a disparity exists between the tax rates upon corporate and individual taxpayers.

4. Administration of Section 531-7

The basic problem, therefore, is not whether the statute should be on the books but how it is to be administered. If its administration is too rigorous, the surtax can represent a threat to business. In prosperous times it may stifle expansion, particularly in the case of small enterprises which do not have ready access to capital markets. Available evidence indicates that retention of profits is a more important source of funds for growing firms than for large, established corporations.[9] In times of recession, on the other hand, the threat of severe administration of Section 531-7 may discourage companies from retaining adequate funds as a necessary cushion, and a sharp drop in prices can dissipate profits reflected in current inventories and force them into insolvency. According to the Senate Committee Report, numerous complaints were received that former Section 102 was prejudicial to small business, that it had been applied in an arbitrary manner in many cases, and was a constant threat to expanding business enterprise. There is no doubt that, in some instances, companies have paid out too much in dividends because of doubtful advice about the application of old Section 102. One frantic call was received by the Internal Revenue Service from a man whose company showed a consistent deficit in past years but who feared he must pay a dividend nonetheless in its first profitable year. To some extent there was justification for such alarm a few years ago, when Question 8 on the 1946 Corporation Income Tax Return Form[10] required all companies to state their reasons for retention if they had distributed less than 70 per cent of their earnings. The implications were two-fold, namely, (1) that 70 per cent was the arbitrary yardstick by which the Treasury determined whether there was improper accumulation, (2) that old Section 102 applied to all corporations, whether public or closely-held.

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[7] *World Publishing Co.* v. *U.S.*, 104 F. Supp. 787 (N.D. Okla. 1952); *Koma, Inc.* v. *Jones*, 1953 P.H. 72,639 (W.D. Okla. 1953).

[8] Richard Kilcullen, *Taxing Accumulation of Corporate Surplus Under Section 102*, page 25. New York: Practising Law Institute, 1947; Richard F. Barrett, "The Section 102 Penalty," *Taxes*, 1946, Vol. 24, page 656.

[9] J. K. Butters and J. V. Lintner, *Effect of Federal Taxes on Growing Enterprises*, page 63. Harvard University Division of Research, 1945.

Both suspicions may for all practical purposes now be laid to rest. Question 8 was eliminated in the 1947 return and the 70 per cent figure does not appear to have been used as a determinative standard by the courts. It is true that until the 1954 act instructions to agents required close attention to returns filed by corporations which had not distributed at least 70 per cent of the earnings as taxable dividends. However, the Senate Committee has branded such a test as "erroneous and irrelevant"[11] and there seems little likelihood of its being relied upon by the Internal Revenue Service in the future. In general, the fixation of a 70 per cent standard appears to be unsound, indeed absurd, in the light of the variant factors on which the needs of a business may depend. Some companies may require 100 per cent or more of their earnings, while others may be accumulating beyond their reasonable needs by keeping any profits at all.

Furthermore, there is no evidence that the penalty tax has been or will be applied to truly public corporations. The discussion in the 1954 Senate Committee Report fully supports this conclusion,[12] pointing out that "as a practical matter, the provision has been applied only in cases where 50 per cent or more of the stock of a corporation is held by a limited group." The only borderline case involved *Trico Products Company,*[13] having approximately 2,000 stockholders. Yet there, although Trico stock was widely traded in, 70 per cent was held by seven of the original owners and only one director was deemed wholly disinterested. The House bill[14] went further and provided a specific statutory exception for any company which had more than 1500 shareholders and no more than ten per cent of the stock of which is held by any individual or family. However, the testimony before the Senate Committee[15] indicated that it would be very difficult for many corporations which were generally recognized to be publicly held to establish from their records that not more than 10 per cent of their stock was held by one person. Yet if publicly held companies were to be exempted, it was recognized that some definition of this type is needed. Thus, because a definition might in fact be too narrow to protect companies which were not vulnerable under existing law, and further "because the tax is not now in practice applied to publicly-held corporations," the Senate Committee[16] considered it desirable to remove the exemption provided in the House bill.

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[10] T. D. Form 1120.

[11] Senate Report, p. 69.

[12] Ibid.

[13] *Trico Products Corp.* v. *Commissioner,* 46 B.T.A. 346 (1942), affirmed (2 Cir. 1943) 137 F. 2d 424 35 AFTR 234, *cert. denied,* 320 U.S. 799 (1943). For a later year: *Trico Products Corp.* v. *McGowan,* 67 F. Supp. 311 W.D. N.Y. (1946), affirmed (2 Cir. 1948) 169 F. 2d 343, 31 AFTR 394.

[14] H.R. 8300, § 532(b)(1).

[15] Senate Report, p. 69.

[16] Ibid.

A recent study for the Joint Committee on the Economic Report[17] has effectively demonstrated the fact that the penalty tax has been applied by the Bureau almost exclusively to corporations which are very closely held—so closely held, in fact, that direct corporate control can be attributed to particular individuals whose circumstances would indicate a financial interest in their personal surtax. According to the analysis of the ten-year assessments (1938 to 1948) 75 per cent involved less than five individuals owning voting stock, and 85 per cent involved less than 10.

A further interesting conclusion derived from the Joint Committee Study involves the size of companies subjected to the surtax. The largest number of taxpayers which were subject to assessment (approximately one quarter) was found to be in the class of concerns having assets ranging from one million to five million dollars. One fifth falls within the class of $500,000 to $1,000,000 and another fifth in the class of $100,000 to $250,000. These facts are not entirely unexpected as the firm has to be on the one hand rich and profitable enough to induce surtax avoidance, but on the other hand small enough to remain closely held.

Viewed objectively, administrative action under old Section 102 indicates that it has been administered with considerable restraint. According to the recent joint committee study,[18] for the years 1940 to 1950 the total number of known assessments under the section numbered only 919, of which less than 100 were made in every year except 1941, 1942, and 1949. Yet there appeared to be doubts in the minds of Congress about past administration. Complaints were received that the section had been applied in an arbitrary manner in numerous instances. The poor record of the Government in litigated cases was interpreted to indicate that deficiencies had been asserted in many cases which were not adequately screened or analyzed. There were further reports that the tax was being used as a threat by revenue agents to induce settlement on other issues.

All these doubts on the part of Congress conduced to the enactment of a number of changes in former Section 102, each of them furnishing greater protection to the taxpayer. In addition to the new credits and deductions provided under the 1954 Act (discussed in 2, above), probably the most fundamental shift is in the burden of proof.[19] (There are other important amendments broadening the test of "reasonable needs of the business," which will be considered below under "Justifications for retention of profits.") Taxpayers in every case may be expected to take advantage of the provisions which enable them to thrust the burden of proof over upon the Government. Upon receipt of notice of a proposed deficiency with respect to the penalty tax, the company may file a statement of the grounds (together with sufficient facts to indicate the basis for the statement) on which it relies to establish the reasonableness of the accumulation. If the taxpayer submits such a statement within the proper time (to be fixed by regulations, but not less than 30 days) the burden of proof will be upon the Government as to whether the accumulation is in excess of the reasonable needs of the business. The burden still remains on the taxpayer under two circumstances:[20] (1) where it fails to file a statement, and (2) where it presents grounds in its statement which are not supported by the facts there contained.

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[17] Taxation of Corporate Surplus Accumulations, prepared for the Joint Committee on the Economic Report by Prof. James K. Hall (82d Cong., 2d Sess., 1952) p. 116.

[18] Joint Committee Study, supra footnote 17 p. 107-109, 116; see also Robert N. Miller, "Improper Accumulations of Surplus—(2) The Lawyer's Task of Giving Advice as to Current Dividend Policy in View of Section 102, IRC," *American University Tax Institute* Lectures, 1948, page 103; Robert N. Miller, "Bureau Policy on Section 102," *Proceedings of New York University Sixth Annual Institute on Federal Taxation*, page 975. New York: Matthew Bender and Company, 1948.

[19] 1954 IRC § 534(a).

The requirement of a statement immediately raises the issue how far the taxpayer should commit itself on paper. In this connection it should be noted that the decision is not being made when the return is filed (as it was in 1946 under Question 8 of the return). The taxpayer is at the litigation stage. There is no danger, then, that conditions might change after the statement, of such a nature as to warrant a shift in defence. But the question still remains: should the statement be general or specific? In all probability vagueness will not be permitted, but a general statement may be advisable under several conditions. In the first place, if the time period (probably 30 days) does not prove adequate to prepare the case thoroughly, further justifications may be developed for the retention of earnings during litigation stages. Secondly, there is in a general statement less likelihood that the Government will claim that taxpayers have restricted themselves to a single theory of defence. The new regulations may furnish some guidance on this question, but until they are published a general statement would appear to be preferable to detailed specifications unless the company has already completed its defence.

This conclusion, however, must not create any inference that the taxpayer might hold back any available arguments in the pre-litigation stage. In the past decisions, there has been common recognition that old Section 102 cases basically presented fact questions.[21] In view of the small number of deficiencies and of cases which have reached the courts, it has been uniformly recommended that a taxpayer dealing with an agent should argue his case in full and present all the available facts. The benefits of withholding are doubtful in comparison with the possibilities of settlement or of convincing an agent that a management's estimate of the needs of a business is entirely justified.

5. Justifications for Retention of Profits

Despite the 1954 amendments, the accumulated earnings tax still poses an immediate problem to every management whose company is substantial in size, profitable, in a strong liquid position, controlled by a few stockholders, and contemplating retention of current earnings. Their primary problem is to ascertain upon what bases such retention can and should be justified. By and large, it may be concluded that the courts have given sympathetic consideration to the taxpayers' claims of need for the profits retained. The cases decided under former Section 102 are directly relevant to the future, except that the Government will henceforward have an even harder time in winning. Not only has the burden of proof been shifted, but the concept of reasonable needs of the business has been relaxed where building and expansion programs are involved—a point which will be discussed separately below. The decisions seem to rest upon the particular needs of the business, which normally fall into four broad categories.

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[20] Ibid; See also Senate Report, p. 70, 71.

[21] For recent statistics and analysis of the Section 102 cases, see the Joint Committee Study *Supra* footnote 17; for the conclusions see p. 156, 174.

Working capital. In general, working capital refers to the three major assets in the current section of the balance sheet: cash, inventory, and accounts receivable. If the taxpayer expects to do a larger volume of business, it will usually need more inventory and larger bank balances. Similarly, if it maintains the same credit terms, it will have more accounts receivable. In the cases since 1939, the courts have been concerned with a period in which companies were either emerging from the depression and facing a larger volume of business induced by the war, or preparing for the uncertainties of the post-war period. Recognizing this fact, the courts appear to have accepted without hesitation the necessity of financing working capital needs out of retained earnings.[22]

In a period of industrial upswing, sales may remain high and prices may rise so that dollar inventories have to be larger even to maintain the same volume. At such a time, it is not unreasonable for corporations to estimate that additional working capital would be required and that a portion of profits should be retained for that purpose.

Should there be a recession, however, working capital estimates would be swiftly altered. In some instances, because of lower inventories and receivables and no further building, the business contraction might result in greater liquidity, and thus some difficulty in justifying further retention. In others, a sharp drop might be reflected in inventory and credit losses which could logically support a previous policy of providing a cushion of accumulated profit (see "Contingencies" below).

New building, expansion, improvements, and repairs. The cases reported recognize that expansion of fixed plant, improvements, and repairs may be financed exclusively through retained earnings without any compulsion to seek new capital or to borrow elsewhere. This rule applies whether the expansion takes the form of the acquisition of competing lines or additional terminals by a transport concern,[23] stores by a drug chain,[24] or new plant or equipment for manufacturing operations.[25]

One of the major concerns among businessmen today, however, is how immediate a prospective expansion to justify retention must be.[26] Some ground for anxiety was afforded by the case of *World Publishing Co.* v. *United States.*[27] Since the expansion program of this corporation, involving a new building and a printing press, was adopted in 1942 but could not be fulfilled until after the war, the court said it was "too remote" to warrant the retention of 100 per cent of the 1942 profits. However, an alternate basis for the decision received much stronger emphasis in the opinion of a lower court: namely, that net quick assets, in stocks, bonds, and cash, were already adequate to carry out the project at then-existing costs. As a matter of fact, the fears generated by the *World Publishing* case were materially allayed by the subsequent Section 102 decision in favor of the same taxpayer by a district court[28] with respect to the retention of the company's earnings in a later year. Some counsel have expressed the view that the district judge over-ruled or, to be technically accurate, ignored the circuit court's opinion, particularly since the reasons on which retention was based in the second case involved the very same building and other matters already under consideration in the first. There is undoubtedly some inconsistency between the two opinions, and the second may reflect the willingness of district judges to decide a fact case of this type independently of a direct precedent which might influence the Tax Court. At the same time, the actual construction and equipment costs were known by the time the second case came to trial, and their substantial increase over original estimates must have exerted a major influence on the court's judgment that existing funds would not suffice to meet the program.

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[22] *Universal Steel Co.*, 5 T.C. 627 (1945); *Walkup Drayage & Warehouse Co.*, Par. 45,241 Prentice-Hall Memorandum T.C. (1945); *National Yarn Corp.*, Par. 50,178 Prentice-Hall Memorandum T.C. (1950); *Shaw and Keeter Motor Co.*, Par. 51,235 Prentice-Hall Memorandum T.C. (1951); *A. H. Phillips, Inc.*, Par. 51,318 Prentice-Hall Memorandum T.C. (1951); *Lannon Manufacturing Co., Inc.*, Par. 52,043 Prentice-Hall Memorandum T.C. (1952); *Korricks, Inc.*, Par. 53,096 Prentice-Hall Memorandum T.C. (1953).

[23] *California Motor Transp. Co.*, Par. 43,192 Prentice-Hall Memorandum T.C. (1943).

[24] *Lane Drug Co.*, Par. 44,131 Prentice-Hall Memorandum T.C. (1944).

[25] *Coca-Cola Bottling Works v. United States*, 53 F. Supp. 992 M.D. Tenn. (1944); *Litchfield Creamery Co.*, Par. 43,458 Prentice-Hall Memorandum T.C. (1943); *National Yarn Corp.*, footnote 22, above; *Lannon Manufacturing Co., Inc.*, Par. 52,043 Prentice-Hall Memorandum T.C. (1952); *Columbus Die Tool and Machine Company* Par. 52,312 Prentice-Hall Memorandum T.C. (1952); *Metal Office Furniture Company*, Par. 52,313 Prentice-Hall Memorandum T.C. (1952); *Korrick's Inc.*, Par. 53,096 Prentice-Hall Memorandum T.C. (1953).

[26] E. B. George and R. J. Landry, "The Shadow of 102 on Dividend Policies," *Dun's Review* 14 (Supp. 1947).

But if there were any dilemma over the so-called immediacy test (under which there must be an imminent need for the funds in order to justify the retention of earnings), it has been largely eliminated under the 1954 Revenue Code. Both the House and Senate favored, and the statute now provides that the reasonable needs of the business shall include "reasonably anticipated" needs.[29] According to the Senate report,[30] it is contemplated that this amendment will cover the case where the taxpayer has specific and definite plans for acquisition of buildings or equipment for use in the business. It would still not apply, however, where the future plans are vague and indefinite, or where execution of the plans is postponed indefinitely.

The Senate Committee[31] also noted the criticism that, in determining the reasonable needs of the business, consideration has been frequently given to events occurring after the close of the taxable year. It agreed with the House that only the facts as of the close of the taxable year should be taken into account in determining whether an accumulation is reasonable. According to the Senate Report, if the retention of earnings is justified as of the close of the taxable year, subsequent events should not be used for the purpose of showing that the retention was unreasonable in that year. They may be considered, however, to determine whether the corporation actually intended to consummate the plans for which the earnings were accumulated.

As a general proposition, the courts in past cases have shown considerable latitude with regard to building programs. For example, where the Tax Court found the existence of a bona fide plan in the year involved, it declared the accumulation of earnings to be justified even though the plan was subsequently modified and no building actually undertaken.[32] In *Goodman Furniture Co.* (to which the Commissioner has acquiesced) the Tax Court found that a program of building one or two branch stores constituted a reasonable basis for retaining profits, and said that the company had never "abandoned its intention" from 1935, when it was first projected, until 1947, when the first site was actually purchased.[33] In another case, the court approved the allocation of earnings to a fund in government bonds for the financing of a building program for the succeeding year, and denied the Government's argument that the company could raise money from outside sources when needs arose.[34] As to the amount of the fund in the case of replacements, as distinguished from new construction, it has been recognized that during planning stages the rising price level may be taken into account in computing anticipated costs.[35]

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[27] 72 F. Supp. 886 (N.D. Okla. 1947), affirmed (10 Cir. 1948), 169 F. 2d 186.

[28] *World Publishing Co.* v. *U.S.*, 104 F. Supp. 787 (N.D. Okla., 1952).

[29] 1954 IRC § 537.

[30] Senate Report, p. 69.

[31] Ibid.

The tax consequence of financing other businesses from the retained earnings of a taxpayer corporation has been somewhat obscure. The old regulations under Section 102 prescribed that "The business of a corporation . . . includes in general any line of business which it may undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax." [36] One of the grounds offered for accumulating the profits in a Tax Court case was that the corporation, engaged in radio broadcasting, might possibly invest in a department store.[37] It was pointed out that such an investment has no bearing on the needs of the petitioner's broadcasting business. It has also been indicated that a proposed venture into radio broadcasting is not necessary for a newspaper.[38] The latter appears to be the most extreme case thus far adjudicated inasmuch as combined newspaper and radio station ownership is a common pattern. It seems reasonably clear that the company is vulnerable if corporate funds are used to finance other businesses which are owned by its shareholders and in which it has no direct interest.[39]

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[32] *Howard Flint Ink Co.*, Par. 42,410 Prentice-Hall Memorandum T.C. (1942); *Columbus Die Tool and Machine Company*, Par. 52,312 Prentice-Hall Memorandum T.C. (1952); *Korrick's, Inc.*, Par. 53,096 Prentice-Hall Memorandum T.C. (1953); *National Yarn Company* Par. 50,178 Prentice-Hall Memorandum T.C. (1950); *Thomas S. Lee Enterprises, Inc.*, Par. 53,228 Prentice-Hall Memorandum T.C. (1953); *Defiance Lumber Co.*, Par. 52,246 Prentice-Hall Memorandum T.C. (1952).

[33] 11 T.C. 64 (1948) (acq.).

[34] *Universal Steel Co.*, 5 T.C. 627 (1945); *Metal Mouldings Corp.*, Par. 43,087 Prentice-Hall Memorandum T.C. (1943). See also *Kennedy Nameplate Co.*, Par. 47,150 Prentice-Hall Memorandum T.C. (1947); *National Yarn Corp.*, Par. 50,178 Prentice-Hall Memorandum T.C. (1950).

[35] *Syracuse Stamping Co.*, Par. 45,118 Prentice-Hall Memorandum T.C. (1945); *World Publishing Co. v. U.S.*, 104 F. Supp. 787 (N.D. Okla., 1952); *Columbus Die Tool and Machine Company*, Par. 52,312 Prentice-Hall Memorandum T.C. (1952).

[36] Reg. 111, § 29.102-3.

[37] *Southland Industries, Inc.*, Par. 46,262 Prentice-Hall Memorandum T.C. (1946).

[38] *World Publishing Co. v. United States*, 72 F. Supp. 886 (N.D. Okla. 1947) 35 AFTR 167, aff'd (10 Cir. 1948), 169 F. 2d 186.

[39] *Latchis Theatres of Keene, Inc.* (also Claremont, Inc.), 19 T.C. No. 20 (1952); but compare *Crawford County Printing and Publishing Company*, 17 T.C. 1404 (1952).

One subject of controversy in the administration of former Section 102 has been the investment of retained earnings in a business enterprise operated through a subsidiary controlled by the taxpayer. According to the Senate Committee Report,[40] under then existing regulations, accumulated profits might be invested only in a business operated directly by the taxpayer. The Senate and House Committees took the position that where the taxpayer has eighty per cent or more of the voting stock of another corporation, the taxpayer should be viewed as though it engaged directly in the business of that company. According to the report, if its ownership of stock is less than eighty per cent, a factual determination should be made as to whether the funds are employed in a business operated by the taxpayer. This position was taken only as to concerns engaged in the active conduct of a trade or business, and definitely not as to investment or personal holding companies. The views expressed jointly by the House and Senate Committees may be expected to be incorporated in the new regulations.

Many cases have involved expansion proposed on account of the war, but the views of the Tax Court should apply with equal logic to other situations requiring expansion. A business may grow through product research, or developing new sales outlets, or purchasing related businesses, as well as actual building construction, but the method seems immaterial as long as earnings are being retained for the reasonable needs of an expanding enterprise.

Contingencies. "Contingencies" is a broad term covering most of the remaining bases upon which the accumulation of earnings may be justified. If the risk can be defined in monetary terms, it may appear as a reserve upon the liability side of the taxpayer's balance sheet.

The courts appear to acknowledge the principle that profits may have to be accumulated for a wide variety of contingencies. For example, they have recognized that a company which suffered losses in preceding years should be permitted to retain profits as it emerges from a depression.[41] Conversely, a prediction of bad times may justify a retention of earnings as a safety factor.[42] The Tax Court has also considered the hazards intrinsic to a business whether it be a tree-nursery firm subject to the risks of weather,[43] or a sales agency facing unsettled prices in coal.[44] In like manner, the cyclical character of an industry has been accepted repeatedly as a basis for retention of profits.[45]

A taxpayer's dependence upon a single customer is another frequently considered factor. In one case the court permitted the accumulation of profits in the form of government bonds adequate either to finance a new plan to keep the customer or to meet an increased advertising appropriation in the event of losing the account.[46] The fear of patent-infringement suits has also been given serious attention as a basis for the maintenance of funds out of profits.[47]

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[40] Senate Report, p. 70.

[41] *R. C. Reynolds, Inc.*, 44 B.T.A. 356 (1941); *Kennedy Nameplate Co.*, Par. 47,150 Prentice-Hall Memorandum T.C. (1947); *Hanovia Chemical & Mfg. Co.*, Par. 43,435 Prentice-Hall Memorandum T.C. (1943).

[42] *Smokeless Fuel Co.*, Par. 43,425 Prentice-Hall Memorandum T.C. (1943).

[43] *Millane Nurseries & Tree Experts, Inc.*, Par. 42,651 Prentice-Hall Memorandum T.C. (1942).

[44] *Smokeless Fuel Co.*, Par. 43,425 Prentice-Hall Memorandum T.C. (1943); *Wean Engineering Co.*, Par. 43,348 Prentice-Hall Memorandum T.C. (1943).

[45] *Universal Steel Co.*, 5 T.C. 627 (1945); *Baker & Co.*, Par. 43,436 Prentice-Hall Memorandum T.C. (1943).

It can be generally said that contingencies claimed as peculiar to a business have been accepted by the courts where there was adequate and clear proof of the potential risk involved. The cases in which the contingencies were deemed insignificant are extreme, such as where a one- or two-man company feared a change in legislation which might affect its insurance business,[48] or alleged the possibility of damage suits justifying the retention of all of its relatively large war profits,[49] or set up a fund which was excessive in comparison with the contingencies or plans proposed.[50]

It is true that some cases cited deal with the war period, when courts might be expected to be particularly lenient in permitting profit accumulations. Uncertainties characteristic of the postwar transition warranted some relaxation in government administration of former Section 102, but, by and large, the cases involved contingencies common to both war and peacetime.[51] Furthermore, the courts have in recent decisions fully recognized the uncertainties, and hence the requirements of business during the years following the end of World War II.[52]

Debt retirement. The regulations under former Section 102 recognized the need for retaining profits to repay certain kinds of debts. For example, a company may generally meet its ordinary debts out of profits.[53] It is expressly permitted to accumulate income that, pursuant to the indenture, is placed to the credit of a sinking fund for retiring bonds previously issued.[54] Further, earnings may be withheld to pay off a bank loan which is soon maturing,[55] but not to meet debts other than those of the taxpayer itself.[56]

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[46] *L. R. Teeple Co.*, 47 B.T.A. 270 (1942). But cf. *Trico Products Corp.* v. *McGowan*, 67 F. Supp. 311, 316-17 W.D. N.Y. (1946), aff'd (2 Cir. 1948), 169 F. 2d 343, 31 AFTR 234.

[47] *Wean Engineering Co.*, Par. 43,348 Prentice-Hall Memorandum T.C. (1943). But cf. *Gibbs & Cox, Inc.* v. *Commissioner* (2 Cir. 1945), 147 F. 2d 60, affirming Par. 43,400 Prentice-Hall Memorandum T.C. (1943); *Trico Products Corp.* v. *McGowan*, 67 F. Supp. 311, 317 W.D. N.Y. (1946), aff'd (2 Cir. 1948), 169 F. 2d 343.

[48] *Albert L. Allen Co.*, Par. 44,381 Prentice-Hall Memorandum T.C. (1944).

[49] *Gibbs & Cox, Inc.* v. *Commissioner* (2 Cir. 1945), 147 F. 2d 60, 35 AFTR 615 affirming Par. 43,400 Prentice-Hall Memorandum T.C. (1943).

[50] *J. M. Perry Co.* v. *Commissioner*, 120 F. 2d 123 (9 Cir. 1941), affirming Par. 40,153 Prentice-Hall Memorandum B.T.A. (1940).

[51] The Case of *Steele's Mills* v. *Robertson*, 32 AFTR 1734 M.D. N.C. (1943), represents an extreme generosity in the determination of funds needed for the business. It may well be chosen to illustrate when a taxpayer should consider bringing his case before a district judge, as distinguished from more sophisticated Tax Court judges. But cf. *World Publishing Co.* v. *U.S.*, 72 F. Supp. 886 N.D. Okla. (1947), affirmed (2 Cir. 1948) 169 F. 2d 186 35 AFTR 1671. In the *Robertson* case, involving a North Carolina textile manufacturing company, the district court permitted the accumulation of profits by the taxpayer in order to maintain net quick assets of between one-half and one million dollars as a safeguard against normal risks and contingencies. In his opinion the judge pointed out that the net quick assets were approximately equal to the reserve for depreciation, and concluded by way of dictum as follows: "While, as a matter of expediency, the corporation has been able to operate successfully by using its reserve for depreciation as operating capital, the court does not think it should be forced to do this, and, that it should be allowed to carry bonds, cash or other liquid assets to equal its reserve for depreciation, and an additional fund for operating capital and reserve against contingencies." 32 AFTR at 1736.

[52] *In re J. S. Barnes, Inc.* (D.C. S.D. Fla. 1953), Par. 72,661 Prentice-Hall Tax Service (1953); *Hansen Baking Co., Inc.*, Par. 53,214 Prentice-Hall Memorandum T.C. (1953); *Columbus Die, Tool and Machine Co.*, Par. 52,312 Prentice-Hall Memorandum T.C. (1952); *Shaw and Keeter Motor Co.*, Par. 51,235 Prentice-Hall Memorandum T.C. (1951).

[53] *Baker & Co.*, Par. 43,436 Prentice-Hall Memorandum T.C. (1943); Thomas M. Tarleau, "Effect of Section 102 Penalty on Current Accumulations of Corporate Earnings," *How Should Corporations Be Taxed?* page 111. New York: Tax Institute, 1947.

Difficulties arise in attempting to forecast the tax results of current techniques, such as the organization of a company with minimum capital and substantial indebtedness as a basis for withholding the entire annual profit.[57] The transaction may vary from ordinary "thin incorporation" [58] in that equity and debt are held by different parties. For instance, a group may form a corporation and transfer real estate in return for its stock; the land may already be mortgaged, or a loan may be immediately obtained and the funds distributed as a return of capital. May profits then be continuously accumulated to pay off the obligation? There are no decisions directly in point, but the result is at least doubtful under *Helvering* v. *Chicago Stock Yards Co.*[59] Here the basic question is one of intent: Was the company formed, or availed of, to avoid surtaxes upon the individual shareholders? Is it a vehicle for retaining profits and ultimately realizing them through sale of the property and liquidation of the business? Inquiry will undoubtedly be made where the evident objective is the conversion of earnings into capital gains, through liquidation or otherwise.

Case illustration. The analysis of a specific case may serve to illustrate the extent to which the courts recognize the taxpayer's need for funds where adequate proof is submitted. *Lion Clothing Co.*, promulgated June 17, 1947,[60] reviews the factors considered above as bases for the accumulation of profits. The taxpayer with a single strong argument to justify the retention of earnings should probably concentrate upon that. But where a corporation is distinctly vulnerable and must rely upon a variety of justifications, *Lion Clothing Co.* may well be taken as the model upon which the case should be presented under Section 102 or its successor Section 531-7. The strength of this case as a precedent has been further bolstered by *Goodman Furniture Co.*[61] By appropriate corporate action in 1938, the taxpayer, a retail clothing concern owned by three persons, one a nominal holder, adopted a policy of accumulating a substantial part of its net profits each year "so that the company might have funds for expansion and any unseen depression that might occur." In the taxable years involved—1940, 1941 and 1942[62]—the cash and bond accounts, after deducting current liabilities, increased substantially, with accounts receivable and inventory dropping to a lesser extent. In addition to the general corporate policy stated in the minutes, the taxpayer relied upon the following as needs of the business: (1) a cash "reserve" based upon the unhappy experience of 1930-32 when losses were suffered and the banks pressed for repayment of their loans; (2) an increase in inventories estimated at $100,000 when clothing became more plentiful; (3) an increase in accounts receivable when government credit restrictions were eliminated, estimated at $50,000; (4) a purchase of $100,000 worth of concessions in the taxpayer's store; (5) improvements such as a freight elevator and new fixtures, estimated at $90,000; and (6) the payment of a mortgage —$105,000 in 1942—which the taxpayer had assumed when the Fox-Gaines Realty Co., owned by approximately the same stockholders and holding title to the building which the taxpayer occupied, merged with it in 1937.

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[54] Reg. 111, § 29.102-3 (1947).

[55] *Gazette Telegraph Co.*, 19 T.C. No. 86 (1951).

[56] *Helvering* v. *Chicago Stock Yards Co.*, 318 U.S. 693 (1943), 30 AFTR 1091, affirming 41 B.T.A. 590 (1940); *Medical Arts Hospital* v. *Commissioner* (5 Cir. 1944), 141 F. 2d 404, affirming Par. 43,189 Prentice-Hall Memorandum T.C. (1943); *Beim Co.* v. *Landy* (8 Cir. 1940), 113 F. 2d 897, 26 AFTR 1189.

[57] The discussion under the four categories above is not intended as an exhaustive coverage of the cases decided since 1939. It is merely an outline of the significant points chosen to illustrate the approach taken by the courts toward the determination of the "reasonable needs of the business." In many instances the cases, being primarily fact cases, actually include matters which might bring them within several or all of the four categories.

Case-by-case analyses may be found in Leahy, 70 *Per Cent*, pages 20-62 (2d ed. 1946). See Tarleau, *op. cit.*, pages 119-123.

[58] M. R. Schlesinger, "Thin Incorporations: Income Tax Advantages and Pitfalls," *Harvard Law Review*, 1947, Vol. 61, No. 50; Allan F. Ayers, Jr. "Risk of Equity Masquerading as Funded Debt in Closely-held Corporations," *Proceedings of New York University Seventh Annual Institute on Federal Taxation*, page 1120. New York: Matthew Bender and Company, 1948.

[59] 318 U.S. 693 (1943).

[60] 8 T.C. 1181 (1947).

[61] 11 T.C. 530 (1948). See also *National Yarn Corp.*, footnote 22, above.

The Tax Court held that the taxpayer had met its burden of proof and that the accumulations were within the reasonable needs of the business. In arriving at its decision the court relied primarily upon the policy adopted by the directors in 1938 and concluded that it was "a reasonable one and has been carried out." The court authorized the accumulation of profits so that the taxpayer would have ample funds on hand without borrowing from banks to finance the above requirements. It concluded by saying that earnings cannot be said to be retained beyond reasonable needs where the purpose is "to retire mortgage indebtedness, to make improvements . . . , to expand operations by purchasing the interests of concessionaires, to accumulate some cash reserves as a bulwark against future depressions, and to meet unknown risks of the war and post-war period."

The *Lion Clothing* case raises for the Government the difficult question of defining the aggregate needs of a business. On one hand, the corporation alleged needs based upon a predicted prosperity: larger inventory and accounts receivable, the purchase of profitable concessions within the store, and proposed expansion through buying more fixtures and equipment. On the other hand, funds were claimed as necessary in order to meet possible depression losses. It would appear that the two types of needs may be valid separately, but can it be said that the Tax Court would accumulate all the alternate needs and then authorize the retention of enough profits to meet the total? There is some basis for deriving this implication from the opinion.

6. Current Sources of Confusion

Audit of return after a change in business. Despite the broad grounds upon which the retention of earnings may be justified, corporate taxpayers may entertain some fears with respect to the administration of Section 531-7. Some of these may be groundless, but others have a foundation in logic. For example, corporations today may well be apprehensive over the fact that their returns will be audited at a different stage of the business cycle than exists in the year of filing. Under such circumstances, reasons for accumulation, though logical today, may not seem plausible some years hence to an agent or court. This problem will be discussed in greater detail below under "Planning."

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[62] From December 31, 1939 to December 31, 1942, the cash, bond, and trust accounts increased from $222,000 to $500,000; the accounts receivable and inventory decreased from $154,000 to $124,000, and the current liabilities (including an obligation to stockholders varying between $66,000 and $55,000) increased from $124,000 to $291,000, excluding mortgage obligations, 8 T.C. 1181.

Over-emphasis upon the size of surplus. Another possible fear is based upon misconceptions as to the significance of a corporation's accumulated surplus. The question might well be raised why size of surplus as such has any relevance to the decision as to whether profits of the year have been retained beyond the needs of a business. The majority opinion in *World Publishing Company*[63] v. *U.S.*, holding the taxpayer liable, tends to emphasize the quantity of a surplus rather than the condition of the asset side of a balance sheet. Perhaps retention of all the profits was beyond the reasonable needs of the newspaper, even though a new printing plant was proposed; its net current assets were $563,000 and the company was continuously profitable. The question is primarily one of determining whether the company has enough liquid funds (*not* surplus) to meet estimated needs, including demands for working capital, plant expansion, and all reasonable contingencies. One may therefore have some cause for concern when a court makes a statement that "It is significant that the accumulated earned surplus upon the taxpayer's books as of December, 1941, was greater than the estimated minimum cost of the new presses, accessory equipment and of the building . . ."[64] The dissenting opinion, however, demonstrates better the general approach by which court decisions should be reached, and is fully supported by the Joint Committee study. According to that study,[65] the data strongly suggest that the critical factor in former Section 102 (now 531) assessments by the Internal Revenue Service, assuming the corporation is closely held and subject to control by a limited number of persons, is corporate liquidity. The report further indicates that the ratio of earned surplus to total assets is not, *per se*, significant because a high ratio may simply represent a long previous ploughback of earnings into real investment—which is a legitimate reason for the retention of earnings. As a general rule, the Tax Court has been realistic, weighing the demand for funds against the available supply without over-emphasizing the surplus account.

Some lack of uniformity in the administration of Section 102. Possible criticism may also exist by reason of a lack of uniformity in administering former Section 102. In general, the Internal Revenue Service has appeared open-minded, but the Senate and House Committees indicate that some agents in the field have forced settlements by threatening to introduce a penalty surtax "red herring" into cases, with the attendant presumptions in favor of the Government. The few known instances where this has happened illustrate the dangers of decentralizing the administration of a provision which turns so heavily upon indeterminate questions of business judgment. The danger is minimized, however, by the fact that the number of deficiencies has been small and that the burden of proof has now been shifted and the severity of the tax reduced by additional credits permitted under the 1954 act. It does, however, raise the possibility that Section 531-7 may be thrown into negotiation by the agent when other items on the return are in issue.

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[63] 72 F. Supp. 886 N.D. Okla. (1947), affirmed (10 Cir. 1948), 169 F. 2d 186.

[64] *World Publishing Company* v. *U.S.*, 35 AFTR 1671, *supra* footnote 63 at page 189.

[65] Joint Committee Study, see footnote 17 supra, p. 123.

Stockholders' suits. One of the recently publicized dangers besetting a corporation by way of the tax penalty is a stockholder's suit. Only a single case of this type has been litigated thus far. In the decisions involving *Trico Products Company,* highly successful manufacturers of windshield wipers, the tax court and the district court (in successive years) have held the corporation liable for substantial surtax penalties in each of the years because of the retention of profits beyond reasonable limits. Several small stockholders then brought a derivative action against the directors on the grounds of mismanagement,[66] the theory being that earnings were not distributed and the risk of Section 102 knowingly assumed primarily because the directors were already in high tax brackets. Recovery for the corporation has been realized by a settlement of $2,390,000.[67] This case demonstrates one of the dangers involved in a closely-held corporation where an outside interest exists and where directors have been placed in a vulnerable position by an unfavorable decision on the penalty itself. Such fears can be alleviated in part by the paucity of cases decided against taxpayers,[68] and by the additional fact that the judgment in a tax case will probably not prevent directors from relitigating the issue in a stockholder's suit. Probably it would be improper to apply collateral estoppel in this situation, and hence payment of the penalty tax by the corporation should not automatically result in the liability of the directors.[69]

The danger of a stockholder's derivative suit should be a caveat to those corporations which knowingly risk the penalties of Section 531. One company is said to be so closely held that it has filed its income tax return in past years together with a payment of the penalty. Others exist in which it would clearly be cheaper to pay the penalty than the additional tax imposed upon the major shareholders if profits were distributed as dividends. The existence of outside shareholders, however, changes the situation and may impose upon the major shareholders-directors an additional cost that has not entered into the calculations.

7. Some Observations on Planning for the Future

Dangers respecting detailed minutes. After available ways to justify the retention of earnings and still-prevailing fears with respect to the administration of the penalty section have been reviewed, there remains the problem of planning future corporate action. For example, tax magazines and services have often recommended the preparation of detailed directors' minutes setting forth the reasons for retaining profits of the year.[70] Clearly, if plans for new building are under way, with the site already purchased, minutes should reflect the progress which has been made. Likewise, if directors reject a proposal because of lack of funds, a statement in the minutes can by implication establish the existence of competing needs in a business. In general, however, there is a common sense danger about being too detailed in citing reasons for withholding dividends that are indefinite or inconsistent, as in *Lion Clothing Co.*[71] The real question is whether reasons written into the minutes initially will constitute the most favorable basis for sustaining the taxpayer's position when the return is audited. During the post-war period, for instance, the claim was usually made that earnings should be retained for physical expansion or additional inventory. Yet in the event of a recession, there may be stronger support for accumulation of funds as a cushion against losses currently suffered. Furthermore, there is always a danger of self-contradiction when plans set forth carefully in the minutes have not been implemented by the time the agent is checking them.

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[66] *Mahler* v. *Trico Products Corp.*, No. A-79948 (Sup. Ct., Erie C'ty, N.Y.).

[67] J. K. Lasser and Robert S. Holzman, "Personal Liability of Directors for Section 102 Surtaxes," *The Controller,* 1948, Vol. 16, page 342.

[68] See Rudick, "Section 102 and Personal Holding Company Provisions of the Internal Revenue Code," *Yale Law Journal,* 1939, Vol. 49, page 181 and Cary, Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102(c), *Harvard Law Review,* 1947, Vol. 60, page 1296. The only Section 102 case decided against the taxpayer beyond 1947 and May, 1949, was *Colonial Amusement Corp.*, Par. 48,149 Prentice-Hall Memorandum T.C. (1948).

[69] A helpful discussion of this problem is contained in "Derivative Actions Arising From Payment of Penalty Tax Under Section 102," *Columbia Law Review,* 1949, Vol. 49, page 394.

[70] See, for example, Prentice-Hall Corporation Services Report Bulletin No. 6 (Dec. 21, 1948).

Forward budgets. It has also been suggested, in connection with planning at the time the profits are retained, that a cash budget be available. It would undoubtedly help in many instances, as would independent reports by management consultants or economists bearing upon the status of a company in its industry. Still, there is always danger in a set of careful calculations based upon management decisions which are never subsequently executed. The same may be said for setting up reserves on the right hand side of a balance sheet out of earned surplus. If a commitment which will be definitely fulfilled does exist, however, then the expression of policy in a balance sheet itself by the creation of a reserve (such as a reserve for new building), and possibly even funding the reserve on the asset side, may be helpful. Several cases have treated reserves and the allocation of cash or U.S. Government bonds to a fund earmarked for a specific expenditure as valuable evidence of planning to meet justifiable needs of the business.[72]

Dividend policy. Attention has been focused thus far upon the accumulation of earnings and relatively little emphasis has been laid upon dividend policy. Specifically, should a management that feels there is adequate justification for retaining the profits of a year continue declaring a dividend nevertheless? Much will depend on the degree of risk faced by a company under the penalty section. If there is likelihood of the imposition of a penalty, it may be advisable to pay out a moderate dividend rather than to discontinue entirely. Though there are no decisions specifically in point, the Tax Court appears in general to weigh a company's dividend policy seriously in determining whether a retention is primarily a means for avoidance of the surtax.

. **Effect of company liquidation or disposition upon Bureau action.** A further aspect of planning is to recognize when penalty surtaxes may be asserted. The old regulations have set forth definite practices which may be treated as indications of a purpose to avoid the surtax.[73] For this reason, counsel should advise vulnerable companies against making loans to stockholders-officers-directors, or investments having no reasonable connection with the business.[74] Apart from these glaring situations, of course, the issue may arise at any time in the history of a closely held concern in a strong liquid position. Whenever companies are contemplating recapitalization, a stock redemption, or liquidation,[75] counsel should weigh in advance the possibility of an examination to ascertain whether or not the action is for the purpose of distributing earnings previously accumulated in violation of Section 531. It is obvious today that some companies are expanding and earnings are being reinvested only so that the firm may be sold or liquidated and its owners realize the accumulated values on a capital gains basis. At the point of disposition, then, the Internal Revenue Service may go as far back as the statute of limitations will permit to determine whether reasons offered for retention in prior years were based soundly upon the facts.

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[71] 8 T.C., 1181 (1947).

[72] *Universal Steel Co.*, 5 T.C. 627 (1945); *Metal Mouldings Corp.*, Par. 43,087 Prentice-Hall Memorandum T.C. (1943); J. K. Lasser and Robert S. Holzman, "The '102' Cases," *Tax Law Review*, 1948, Vol. 3, pages 119, 145.

[73] Reg. 111, § 29.102-2 (1943).

[74] See in this connection *Latchis Theatres of Keene, Inc.* (also Claremont, Inc.), 19 T.C. No. 20 (1952).

Conduct of litigation. Decisions since the war raise a possibility that litigation of a difficult penalty tax case might better be conducted before a local federal district court, with or without a jury. Knowledge of the attitudes of the judges and juries in the locality would of course be prerequisite to recommending the payment of the tax and suit for refund. The facts are, however, that there are jury verdicts in favor of the assessed company in cases which might have been decided by the Tax Court in favor of the government.[76] District courts, moreover, have held for the taxpayer with respect to later tax years on facts which were markedly similar to those recited in circuit opinions upholding the government's assessment against the same party as to earlier years.[77] Though it would be premature to generalize, the tendency appears to exist in certain districts to treat each case as a fact case, involving questions of intent and the reasonable needs of the business, and to decide them independently of any precedent developed in Tax Court and court of appeals decisions. These possible advantages in a federal district court must now be weighed against the new benefit available to the taxpayer under the 1954 Code of Internal Revenue; i.e., shifting the burden onto the government in Tax Court proceedings.

8. Conclusion

To return to the introductory remarks, it may be that businessmen and their counsel have been unduly disturbed over the penalty attached to Section 531 without appreciating the limited scope of its enforcement. Certainly the concern over the tax has been further alleviated by the 1954 amendments. The basic source of confusion has been the uncertainty of its impact—an uncertainty which may well be necessary as an effective deterrent against the abuse of closely-held operating companies. Despite this concern, it may be advisable to risk the penalty consciously in some instances where the principal holders are already in high individual surtax brackets and no outside stockholders will bring a derivative suit. Furthermore, where a retention of earnings has been *bona fide*, or even where a company has expanded primarily to keep its profits rather than distribute them, reasons sustained by the courts are available to justify management's decision. From a political standpoint, the Internal Revenue Service itself is confronted with obstacles in attempting a too rigorous enforcement of Section 531. Strong public policy favoring the growth of small business should continue to prevent it from deviating sharply from the past history of the administration of this statute.

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[75] Darrell, Norris, "Recent Developments in Nontaxable Reorganizations and Stock Dividends," *Harvard Law Review*, 1948, Vol. 61, pages 958, 963. See in this connection *Koma, Inc.*, Par. 49,284 Prentice-Hall Memorandum T.C. (1949); affirmed (10 Cir. 1951), 189 F. 2d 390; *Bride* v. *Comm.*, Par. 72,828 Prentice-Hall (8 Cir. 1955).

[76] *Koma, Inc.* v. *H. C. Jones*. 1953 Prentice-Hall Par. 72,639 (W.D. Okla. 1953); see also *Kaufman Investment Co.* v. *Scofield*, 1953 P.-H. Par. 72,589 (D.C. W.D. Tex. 1952).

[77] Compare *World Publishing Co.* v. *U.S.* 104 F.S. 784 (N.D. Okla. 1952) involving the year 1944 with *World Publishing Co.* v. *U.S.* 169 F. 2d 186 (C.C.A. 10th, 1948) involving the years 1942 and 1943. Also compare *Koma, Inc.* v. *H. C. Jones*, see above footnote 76, involving the year 1947 with *Koma, Inc.* v. *Com.*, see above footnote 75, involving 1943 and 1944.

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48

Distributions in Redemption of Stock

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In the planning stages, this chapter was entitled "Section 115(g) Problems." That section of the Internal Revenue Code of 1939 was probably better known (and more respected?) by most tax practitioners than the Ten Commandments. Although as a result of the enactment of the Internal Revenue Code of 1954, the familiar section number is gone, the substance, as well as the memory, lingers on.

1. Points to Consider

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2. The Nature of the Problem

The natural appetite of taxpayers for the more palatable dish of capital gains has led some of them to use certain of the sweeter Code provisions for purposes for which the provisions were not intended. After the Supreme Court had held that the ordinary stock dividend was not taxable, it became easy (and pleasant!) to conduit money out of the corporation's till into the pocketbooks of its shareholders through the medium of issuing stock as a dividend and of redeeming it later, thus converting ordinary income into capital gains, with resulting tax savings. In order to prevent such tax avoidance, the forebear of Section 115(g) was born in 1921,[1] and ever since that time the question of whether the money or property received from a corporation in exchange for its stock will be treated as an ordinary dividend, or as the proceeds of sale of a capital asset, has been one of the most vexing problems encountered by the tax practitioner.

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Under both the 1939 and 1954 Codes, every distribution (except of stock or of rights to acquire stock in the distributing corporation) made by a corporation to a shareholder with respect to its stock, out of earnings and profits accumulated after February 28, 1913, or out of earnings and profits of the taxable year, is treated as a dividend, unless a different treatment is specifically authorized.[2] Accordingly, when a corporation acquires its own stock and pays therefor in cash or property, there is manifestly a distribution to its shareholder which would be taxable as ordinary income (assuming the existence of sufficient earnings and profits), unless a specific escape route is found in some statutory provision.

3. The Ways to Capital Gain Treatment

Under the 1939 Code, escape routes were provided for distributions made by a corporation (1) in redemption of a portion of its stock, if the distribution is not essentially equivalent to a dividend,[3] or (2) in redemption of stock of a decedent, under the conditions and within the limitations prescribed in the statute,[4] or (3) in complete liquidation of the corporation.[5] In the 1954 Code no new routes have been created,[6] but some of the old ones have been more clearly marked. As a result, the pre-existing area of uncertainty has been somewhat contracted.

4. Not Essentially Equivalent to a Dividend

The question most frequently arising, when a corporation distributes property in exchange for its own stock, is whether the distribution is essentially equivalent to a dividend. This question is a factual one, the answer to which is often clouded with doubt.

Inasmuch as the test of essential equivalence continues in effect in the 1954 Code, it is important, in future, as well as past, transactions to examine the cases for the purpose of ascertaining the circumstances under which a stock redemption has been adjudged to be essentially equivalent to a dividend.

a. Net effect test. In dealing with the problem, reference has been made in a number of cases to the "net effect" test.[7] The application of that test is manifestly consistent with the language and purpose of the statutes; but the test, as the courts have said, is whether the net effect is a *dividend* and not, as the Commissioner has contended, whether the net effect is the distribution of corporate earnings.[8] That contention seems clearly untenable, and so far as is known no court has ever accepted it. It runs counter to the clear statutory language which says merely that those distributions in redemption of stock shall be treated as dividends which have the essential characteristics of *dividends*. Moreover, the contention is at war with those statutory provisions which put an express stamp of approval on the capital gain treatment of certain distributions, even though they are made out of earnings.

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[1] Application of the original statute was limited to the cancellation or redemption of stock issued as a dividend. In 1926 this limitation was removed, and, with only one minor change, the section familiarly referred to as "115(g)" has continued in effect until the advent of the 1954 Code. The 1950 Act enlarged and subdivided Section 115(g) so that what was formerly Section 115(g) became Section 115(g)(1). The substance of Section 115(g)(1) is found in the 1954 Code in Sections 302(b)(1) and 346(a)(2).

[2] 1954 IRC § 301(a) and (c)(1); 1939 IRC § 115(a).

[3] 1954 IRC §§ 302(b), 331(a)(1) and 346; 1939 IRC § 115(c) and (i).

[4] 1954 IRC § 303; 1939 IRC 115(g)(3).

[5] 1954 IRC § 331(a)(1); 1939 IRC § 115(c).

[6] Except one having limited application, dealing with the redemption of stock issued by railroad corporations in certain reorganizations. 1954 IRC § 302(b)(4).

There is an obvious and important distinction between a dividend and a distribution of earnings. While all ordinary dividends are distributions of earnings, the reverse does not hold true. For instance, in the case of a complete liquidation, there is usually a distribution of earnings, but it does not bear the earmarks of a dividend. The same thing is true of a genuine sale or partial liquidation, discussed below. A dividend is a ratable distribution of earnings made by a corporation to its stockholders, which does not alter the stockholder's proportionate interest in, or control of, the corporation. In distributing a dividend, a corporation intends to divest itself permanently, not temporarily, of the transferred assets. A dividend, accordingly, has well defined features and consequences from the standpoint not only of the corporation but also of its stockholders, and in determining whether a distribution is essentially equivalent to a dividend its effect upon both the corporation and its stockholders should be considered.

Because of the factual nature of the test of essential equivalence, each case must be decided on the basis of its own facts. The regulations promulgated under the old law specifically so stated, and there is ample case authority to that effect.[9] In the Senate Finance Committee report on the 1954 Code it is stated, ". . . your Committee intends to revert in part to existing law for making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon a factual inquiry."[10] Accordingly, in determining whether a distribution is essentially equivalent to a dividend, all the pertinent facts and circumstances will be considered. The many decisions dealing with the subject provide fairly accurate and complete guides to the factors deemed material and to the weight to be accorded them.

b. Form of the transaction. It is clear that substance, not form, should be the controlling test of whether a distribution is essentially equivalent to a dividend. While the transaction should, of course, be cast in a form expressive of its real nature, the formal aspects should and will have only evidentiary value.[11] However, there has been considerable litigation resulting from attempts to make the form of the transaction controlling. Section 115(g)(1) of the 1939 Code speaks of distributions in "cancellation or redemption" of stock, and considerable controversy raged at one time as to whether by placing acquired stock in the corporation's treasury, instead of cancelling or retiring it, the application of that section was avoided. Some of the older cases seem to sanction the use of that escape route,[12] but it is clear that no reliance should be placed thereon. On both reason and preponderant authority, the grasp of the statute cannot be avoided through the simple device of holding the "purchased" stock as treasury stock.[13] Any possible question respecting the matter in future redemptions is laid at rest by a provision in the 1954 Code that "stock shall be treated as redeemed if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock." [14]

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[7] *E.g., Flanagan* v. *Helvering* (Cir. D.C. 1940), 116 F. 2d 937, 26 AFTR 223; *John L. Sullivan*, 17 T.C. 1420 (1952), affirmed (5 Cir. 1954) 210 F. 2d 607; *Samuel L. Cantor*, par. 53,182 Prentice-Hall Memorandum T.C. (1953).

[8] *Fred B. Snite*, 10 T.C. 523 (1948), affirmed (7 Cir. 1949) 177 F. 2d 819, 38 AFTR 841. In *Riddlesbarger* v. *Commissioner of Internal Revenue* (7 Cir. 1952), 200 F. 2d 165 at 175, 42 AFTR 930, the Court stated: "It is true, no doubt, as argued by the Commissioner, that the accumulated earnings of the parent company were reduced by the exchange in controversy. It does not follow, however, that such exchange is equivalent to the payment of a dividend."

[9] Reg. 118, § 39.115(g)-1-(a)(2); *Hyman* v. *Helvering* (Cir. D.C. 1934), 71 F. 2d 342, 14 AFTR 270, cert. den. 293 U.S. 570 (1934); *Clarence R. O'Brion*, par. 51,373 Prentice-Hall Memorandum T.C. (1952).

[10] Sen. Rep. p. 233.

Where a corporation makes a *bona fide* purchase of its stock for a valid business reason, with the intention of reselling, rather than of redeeming, it, the stock should, of course, be held as treasury stock. In such a case there is no "distribution" within the intendment of the law, which is a distribution having the characteristics of a dividend: a ratable, *permanent* transfer of the assets representing earnings. Moreover, there is no "cancellation or redemption," either in fact or in effect, as those words are used in the 1939 Code.

c. Purpose of the redemption. In applying the essential equivalence test, the underlying motives and purposes of the redemption will receive careful scrutiny and consideration. Bearing thereon are the relationship between the issuance and redemption of the stock,[15] the amount of time elapsing between the two,[16] and the corporation's dividend record.[17] If it appears that tax avoidance provides the sole or controlling motive for the redemption, the distribution will probably be treated as ordinary income.[18] But even if there is no tax avoidance motive involved, the distribution may still be treated as ordinary income, since the crucial question is whether the net effect thereof is the payment of a dividend, and not whether the taxpayer's motives are pure.[19]

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[11] *E.g., James D. Robinson*, 27 B.T.A. 1018 (1933), affirmed (5 Cir. 1934) 69 F. 2d 972, 13 AFTR 915. "'As the taxpayer may not, in view of the statute, avoid the tax by an artificial device of empty forms . . . so the Government may not . . . impose a tax merely because there has been a stock redemption, where the circumstances are free from artifice and beyond the terms and fair intendment of the provision.' Pearl B. Brown, Executrix, *supra*, 907." G. E. *Nicholson*, 17 T.C. 1399, 1403 (1952). (Government appeal to 10 Cir. dismissed, nonacq. withdrawn and acq. announced.)

[12] *Commissioner* v. *Alpers* (2 Cir. 1942), 126 F. 2d 58, 28 AFTR 1282. See also, *Kirschenbaum* v. *Commissioner* (2 Cir. 1946), 155 F. 2d 23, 34 AFTR 1292, cert. den. 329 U.S. 726; *Commissioner* v. *Snite* (7 Cir. 1949), 177 F. 2d 819, 38 AFTR 841; *Isaac C. Eberly*, par. 51,351 Prentice-Hall Memorandum T.C. (1951).

[13] *E.g., Wall* v. *United States* (4 Cir. 1947), 164 F. 2d 462, 36 AFTR 423; *James F. Boyle*, 14 T.C. 1382 (1950), affirmed (3 Cir. 1951) 187 F. 2d 557, 40 AFTR 308, cert. den. 342 U.S. 817 (1951); *Zenz* v. *Quinlivan* (D.C., W.D. Ohio 1952) 106 F. Supp. 57, 42 AFTR 461, reversed (6 Cir. 1954) 213 F. 2d 914. See, also, *Raymond F. Koepke*, T.C. Memo. 1954—167.

[14] 1954 IRC § 317(b).

[15] *Shelby H. Curlee, Trustee*, 28 B.T.A. 773 (1933)(nonacq.), affirmed sub. nom. *Randolph* v. *Commissioner* (8 Cir. 1935), 76 F. 2d 472, 15 AFTR 1152, cert. den. 296 U.S. 599, *Joseph W. Imler*, 11 T.C. 836 (1948)(acq.); *Marjory K. Hatch*, T.C. Memo. 1954-8. See Section 7 of this chapter. *Cf. Hill* v. *Commissioner* (4 Cir. 1933) 66 F. 2d 45, 12 AFTR 917; E. M. *Peet*, 43 B.T.A. 852 (1941).

[16] *H. F. Asmussen*, 36 B.T.A. 878 (1937)(acq.); *James D. Robinson* v. *Commissioner* (5 Cir. 1934), 69 F. 2d 972, 13 AFTR 915.

[17] *Hirsch* v. *Commissioner* (9 Cir. 1941), 124 F. 2d 24, 28 AFTR 580; *Goldstein* v. *Commissioner* (7 Cir. 1940), 113 F. 2d 363, 25 AFTR 374; *Fostoria Glass Co.* v. *Yoke* (D.C., N.D. W. Va. 1942), 45 F. Supp. 962, 29 AFTR 1115. *Cf. McGuire* v. *Commissioner* (7 Cir. 1936), 84 F. 2d 431, 19 AFTR 246; *Ira F. Searle Estate*, par. 50,261 Prentice-Hall Memorandum T.C (1950); *Clarence R. O'Brion*, par. 51,373 Prentice-Hall Memorandum T.C. (1951).

Where the distribution to the stockholders is ratable (or substantially so), the establishment of a sound corporate business purpose will probably be necessary to avoid treatment as ordinary income. While various business purposes have been relied on,[20] the one most commonly urged with success is the contraction of the business.[21]

The acquisition by the corporation of its own stock for the purpose of reducing or eliminating indebtedness of a stockholder has been deemed in instances to constitute a valid business purpose,[22] particularly where it resulted from pressures emanating from creditors.[23] However, it is felt that too much reliance should not be placed on such a business purpose.

It is frequently found necessary, or at least desirable, to permit competent executives to acquire a stock interest in a corporation. Ordinarily, this objective can be accomplished, without incurring any risks or problems whatsoever, either through direct sales by stockholders to the executive or through the sale by the corporation to the executive of unissued stock. However, in instances, the only feasible course to pursue may be for the corporation to purchase stock from its stockholders and then resell it to the executive. In such cases, where the corporation makes a bona fide purchase of its own stock with a view to holding it only temporarily and then reselling it to a key man, the transaction should qualify for capital gain treatment, not only because of the sound business purpose involved, but also because it is in reality a "sale," rather than a redemption.[24]

d. Prorata or non-prorata nature of redemption. In many of the redemptions governed by the 1939 Code, the crucial question has been whether there was a resulting substantial change in the stockholders' proportionate interest in, and control of, the corporation. The ordinary dividend connotes a distribution to stockholders on a ratable basis, which leaves their proportionate interests unchanged. A ratable redemption was, therefore, generally considered essentially equivalent to a dividend.[25] Moreover, since the test imposed is one of *essential* equivalence, an exactly proportionate distribution is not required to classify it as a dividend.[26]

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[18] "The cases are many in holding that circuitous approach to the distribution of profits is ineffective if the tax-avoidance motive be present by admission or by necessary inference from the record." *William W. Wood,* par. 43,488 Prentice-Hall Memorandum T.C. (1943).

[19] *Flanagan* v. *Helvering* (Cir. D.C. 1940), 116 F. 2d 937, 26 AFTR 223; *Rheinstrom* v. *Conner* (6 Cir. 1942), 125 F. 2d 790, 28 AFTR 1145, cert. den. 317 U.S. 654. *Cf. Clarence R. O'Brion,* par. 51,373 Prentice-Hall Memorandum T.C. (1951).

[20] *E.g.,* in *Daisy Seide,* 18 T.C. 502 (1952), it was the elimination of a substantial arrearage in dividends on the preferred stock redeemed.

[21] *E.g., Commissioner* v. *Champion* (6 Cir. 1935), 78 F. 2d 513, 16 AFTR 416; *Heber Scowcroft Inv. Co.,* par. 45,235 Prentice-Hall Memorandum T.C. (1945); *Samuel A. Upham,* 4 T.C. 1120 (1945)(acq.); *L. M. Lockhart,* 8 T.C. 436 (1947); *Joseph W. Imler,* 11 T.C. 836 (1948)(acq.); *Clarence R. O'Brion,* par. 51,372 Prentice-Hall Memorandum T.C. (1951); *Favrort* v. *Scofield* (W.D. Tex. 1952); *John L. Sullivan,* 17 T.C. 1420 (1952), affirmed (5 Cir. 1954), 210 F. 2d 607; *Estate of Vannie E. Cook,* T.C. Memo. 1954-133. *Cf. Estate of Charles D. Chandler,* 22 T.C. 1158 (1954).

[22] *Bona Allen, Jr.,* 41 B.T.A. 206 (1940)(nonacq.); *R. W. Creech,* 46 B.T.A. 93 (1942)(acq.); *Isaac C. Eberly,* par. 51,351 Prentice-Hall Memorandum T.C. (1951); *John L. Sullivan,* 17 T.C. 1420 (1952), affirmed (5 Cir. 1954), 210 F. 2d 607. *Cf. J. Natwick,* 36 B.T.A. 866 (1937); *William W. Wood,* par. 43,488 Prentice-Hall Memorandum T.C. (1943).

[23] *Isaac C. Eberly,* par. 51,351 Prentice-Hall Memorandum T.C. (1951); *Ada Murphy McFarlane,* T.C. Memo. 1954-40.

[24] *Commissioner* v. *Snite* (7 Cir. 1949), 177 F. 2d 819, 38 AFTR 841. See, also, *H. F. Asmussen,* 36 B.T.A. 878 (1937).

On the other hand, a substantially disproportionate distribution has been, and should continue to be, a very important, if not controlling, element in the taxpayer's favor,[27] even if it does not meet the "substantially disproportionate" test of the 1954 Code.[28]

It should be noted that the 1954 Code expressly provides that in determining whether a redemption is essentially equivalent to a dividend, its failure to pass the "substantially disproportionate" test or the "termination of interest" test[29] "shall not be taken into account." [30] It is therefore apparent that by adopting specific tests, Congress did not intend to impinge upon the pre-existing general test of essential equivalence.

e. Redemption of stock by related corporation. Under Section 304 of the 1954 Code (as under Section 115(g)(2) of the 1939 Code) the redemption of the stock of a parent corporation by its subsidiary will be treated as if the redemption had been made by the parent. The determination of the amount which is considered a dividend is made as if the property were distributed by the subsidiary to the parent and immediately thereafter distributed by the parent.[31]

In the 1954 Code, the same principle is extended to so-called "brother-sister corporations," by providing that in any case in which there is common control (as defined in the statute) of each of two corporations, and a sale of the stock of one of the corporations is made to the other, the proceeds of such sale shall be considered as being distributed in redemption of the stock of the acquiring corporation.[32] The determination of the amount of the resulting dividend is controlled by reference to the earnings and profits of the acquiring corporation.[33] Thus an avenue of escape which previously existed in the case of affiliated corporations has been effectively closed.

The amount received from the sale of stock in one corporation to a related corporation will accordingly be treated as ordinary income, unless the distribution

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[25] Reg. 118, Sec. 39.115(g)-1(a)(2).

[26] *James D. Robinson*, 27 B.T.A. 1018 (1933), affirmed (5 Cir. 1934) 69 F. 2d 972, 13 AFTR 915; *Hyman* v. *Helvering* (Cir. D.C. 1934), 71 F. 2d 342, 14 AFTR 270, cert. den. 293 U.S. 570 (1934); *J. Natwick*, 36 B.T.A. 866 (1937); *W. & K. Holding Corp.*, 38 B.T.A. 830 (1938). See, also, *Raymond F. Koepke*, T.C. Memo. 1954-167.

[27] "To be sure, it is not a *sine qua non* of a taxable dividend that the distribution be made *pro rata* among the stockholders. But the fact that an alleged distribution is highly disproportionate raises a serious question whether it is in truth a disguised dividend." *Daisy Seide*, 18 T.C. 502 (1952). See, also, *Harry A. Koch*, 26 B.T.A. 1025 (1932); *H. F. Asmussen*, 36 B.T.A. 878 (1937); *Henry V. Foster Estate*, par. 44,091 Prentice-Hall Memorandum T.C. (1944); *R. W. Creech*, 46 B.T.A. 93 (1942)(acq.); *Rosemary Case Weir Trust*, par. 52,199 Prentice-Hall Memorandum T.C. (1952); Rev. Rul. 54-230, 1954 I.R.B. No. 25 (p. 7).

[28] Discussed in Section 5 of this Chapter.

[29] Discussed in Section 6 of this Chapter.

[30] 1954 IRC § 302(b)(5).

[31] 1954 IRC § 304(b)(2)(B).

[32] 1954 IRC § 304(a)(1).

[33] 1954 IRC § 304(b)(2)(A).

(1) is not essentially equivalent to a dividend, or (2) is a substantially disproportionate redemption, or (3) effects a complete termination of the shareholder's interest, or (4) is a qualifying redemption of stock of a decedent's estate to pay death taxes and funeral and administration expenses. If the distribution comes within any of the first three categories, it qualifies for capital gain treatment under Section 302(b) of the 1954 Code. The determination of whether the distribution so qualifies is to be made by reference to the stock of the issuing corporation.[34]

The application of Section 304 of the 1954 Code depends upon the existence of control of one corporation by another corporation, or upon the common control of the two corporations. Control is therein defined as the ownership of stock possessing at least 50 per cent of the total combined voting power of all classes of voting stock, or at least 50 per cent of the value of shares of all classes of stock.[35] In determining whether control exists, the constructive ownership rules of Section 318(a) (without regard to the 50 per cent limitation contained in Section 318(a)(2)(C)) are applicable.[36]

5. Substantially Disproportionate Redemption

As previously pointed out, under the 1939 Code, where the redemption was substantially disproportionate it doubtless qualified for capital gain treatment, because its nature and effect are such that it is not essentially equivalent to a dividend. However, because of the elastic factual nature of the test, such a redemption could be, and sometimes was, challenged by the Commissioner. In order to limit the area of uncertainty in this field, a mathematical test is prescribed in the 1954 Code, the passing of which assures capital gain treatment.[37] The test requires that the following conditions exist:

1. Immediately after the redemption the shareholder must own less than 50 per cent of the total combined voting power of all classes of stock entitled to vote.
2. The percentage of voting stock owned by the shareholder immediately after the redemption must be less than 80 per cent of the percentage of the voting stock owned by the shareholder immediately before the redemption. It would appear that "voting stock" refers to voting power rather than value, even though the statute does not so state, particularly in view of the express reference to value in the condition of the statute mentioned in the next paragraph.
3. If there is more than one class of common stock outstanding, the percentage of the fair market value of all the common stock owned by the taxpayer (voting and non-voting) after the redemption must be less than 80 per cent of the percentage of the fair market value of such stock owned by him prior thereto.
4. The redemption must not be made pursuant to a plan, the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.[38]

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[34] 1954 IRC § 304(b)(1).
[35] 1954 IRC § 304(c)(1).
[36] 1954 IRC § 304(c)(2).
[37] 1954 IRC § 302(b)(2).
[38] For example: "A corporation has, as its sole capitalization, 100 shares of common stock outstanding. Shareholder A owns 55 shares and shareholder B 45 shares. Shareholders A and B are unrelated. In 1955, pursuant to a plan the corporation redeems 12 shares of the stock of

In the 1954 Code, there have been introduced into the law the so-called "constructive ownership" or "attribution" rules,[39] which have probably changed and restricted the pre-existing law relating to corporate redemptions more than any of the other new provisions. Under those rules, the ownership of stock by one person or entity is imputed to another person or entity related in the manner set forth in the rules. For example, an individual is considered as owning the stock owned, directly or indirectly, by his spouse (unless legally separated or divorced by decree), children, grandchildren and parents. Similarly, stock owned by a partnership, estate, trust or corporation may be imputed to its partners, beneficiaries or stockholders, and vice versa. If a person has an option to acquire stock, such stock is considered as owned by such person.

In determining whether a redemption is substantially disproportionate, stock constructively owned by the shareholder, as well as that actually owned by him, will be taken into account.[40] Thus a redemption which would qualify as substantially disproportionate if viewed solely from the standpoint of stock actually owned, may fail to qualify because of stock constructively owned.

Cases may arise where the facts do not meet the technical requirements relating to a substantially disproportionate redemption. Suppose, for example, a controlling stockholder's stock was redeemed to such an extent that after the redemption he owned one-half the corporation's outstanding stock. The stockholder's position has undergone a substantial change, even though he may not have been reduced to the status of a minority stockholder. While such a redemption does not pass the mathematical statutory test, it may, nevertheless, qualify as a redemption which is not essentially equivalent to a dividend, and the fact that the distribution is substantially disproportionate will doubtless be a persuasive element in the taxpayer's favor.

6. Termination of Shareholder's Interest

Since 1928, the Regulations have expressly provided that a distribution in redemption of all the shares of a stockholder, so that he ceases to be interested in its affairs, is not essentially equivalent to a dividend.[41] Manifestly, such a distribution does not have the net effect of a dividend.

The 1954 Code contains an express provision (which appears merely to gild the lily) that the "complete redemption of all the stock of the corporation owned by the shareholder" shall be treated in the same manner as the sale of a capital asset.[42] However, the application of the old rule has been considerably restricted,

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shareholder A and none from shareholder B. Such redemption standing alone qualifies as a disproportionate redemption within the meaning of section 302(b)(2). In 1956, pursuant to the plan, the corporation redeems 10 shares of shareholder B's stock and none from shareholder A. This redemption, standing alone, would also have qualified as a disproportionate redemption within the meaning of section 302(b)(2). However when the two transactions are reviewed (sic) together it is apparent that shareholders A and B have not sufficiently changed their respective proportionate interests in the corporation. Accordingly, under the rule of subparagraph (D), both redemptions would fail to qualify as substantially disproportionate." Sen. Rep. pp. 234-235. See also *Raymond F. Koepke,* T.C. Memo. 1954-167.

[39] 1954 IRC § 318(a).

[40] 1954 IRC § 302(c)(1).

[41] Reg. 118, § 39.115(g)-1-(a)(2).

[42] 1954 IRC § 302(b)(3).

because in determining whether all the stock of a shareholder is redeemed, the above mentioned constructive ownership rules are to be applied.[43] Accordingly, even though all the stock actually owned by a shareholder is redeemed, the redemption may fail to qualify under the termination of interest rule because the ownership of other stock is attributed to such stockholder.

In the case of a complete termination of a shareholder's interest (but not in the case of a disproportionate redemption) the family attribution rule (which imputes to an individual stockholder the ownership of stock owned by his spouse, children, grandchildren, and parents) will not apply:[44]

1. if immediately after the redemption the distributee himself has no interest in the corporation as officer, director or employee, or otherwise (except as a creditor), and if he does not acquire such an interest (other than stock acquired by bequest or inheritance) within ten years from the date of the distribution; and
2. if the distributee files an instrument agreeing to preserve all pertinent records and to notify the Commissioner of the acquisition by him of any prohibited interest; and
3. if no portion of the distributee's stock was acquired by him, directly or indirectly, within the ten year period ending on the date of distribution, from a person the ownership of whose stock would, at the time of distribution, be attributable to the distributee under the constructive ownership rules; but this condition shall not apply if such acquisition by the distributee did not have as one of its principal purposes the avoidance of Federal income tax; and
4. if there is no person who owns, at the time of distribution, any of the corporation's stock that is constructively owned by the distributee, and who acquired any of the corporation's stock, directly or indirectly, from the distributee, within said ten year period, unless such stock so acquired from the distributee is redeemed in the same transaction; but this condition shall not apply if such disposition by the distributee did not have as one of its principal purposes the avoidance of Federal income tax.

If the distributee acquires a prohibited interest within the ten year term, the period of limitations respecting his tax liability is extended to permit the assessment of an appropriate additional tax.[45]

As in the case of substantially disproportionate redemptions, if the redemption does not qualify under the letter of the statute, as one in complete termination of a shareholder's interest, it may, nevertheless, qualify for capital gain treatment, as a redemption which is not essentially equivalent to a dividend.[46]

In cases arising under the 1939 Code, where a shareholder's stock was redeemed and the remaining stock (or a substantial part thereof) was owned by members of his family, the Commissioner has argued that there was no termination of the shareholder's interest in the corporation, because all the stockholders should be considered as a unit in determining whether the redemption was essentially equivalent to a dividend.[47] Assuming that the argument possessed merit from an equitable standpoint, there was little, if any, statutory basis therefor. Moreover, there was no way to tell where the line should be drawn. Should the family group include the husband and wife only, or should the children be included, or should the family group be even larger? Although the problem did not arise often, the Tax Court took a very liberal view, regardless of the degree of relationship existing between the taxpayer and the other stockholders.[48] But the doubts and questions of this nature have been removed in respect to redemptions made after the effective date of the 1954 Code.

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[43] 1954 IRC §§ 302(c)(1) and 318(a).
[44] 1954 IRC § 302(c)(2).
[45] 1954 IRC § 302(c)(2)(A).
[46] 1954 IRC § 302(b)(5).

a. Sale of part of stock to other stockholders and redemption of balance. Where a person owns all the stock of a corporation and desires to liquidate his entire interest, he may want to afford his key employees the opportunity of continuing the operation of the business. Because of their inability to finance the purchase of all the stock, it may be found desirable to sell a portion of the stock to the employees and the balance to the corporation. In such cases, the sequence of the two transactions may (even though it should not) have important tax consequences under either the 1939 or the 1954 Code.

If the stockholder first sells a portion of his stock to the corporation and then sells the balance to the individuals, it might be held on technical grounds that the proceeds of the sale to the corporation should be treated as ordinary income, because the stockholder's proportionate ownership and control of the corporation was not affected by the first sale.[49]

On the other hand, if the order of the two transactions were reversed, the corporation would be acquiring the stockholder's entire remaining interest in the corporation, and it seems clear that the corporate acquisition should not be considered essentially equivalent to a dividend, either from a technical or a substantive standpoint.[50] A Federal District Court reached a contrary conclusion, upon the fallacious ground that the net effect of the transaction was a distribution of the corporation's earnings; but the error was corrected on appeal.[51] As previously pointed out, the test is whether the net effect is a dividend, and not whether the net effect is a distribution of earnings. Where the stockholder's entire stock is redeemed, it seems unrealistic and improper to say that he received the equivalent of a dividend, inasmuch as a dividend does not have the effect of extinguishing a stockholder's interest. Moreover, such a redemption comes clearly within both the letter and the spirit of the Commissioner's Regulations under the 1939 Code and of the provisions of the 1954 Code, relating to the termination of a shareholder's interest. It would seem, therefore, that any further question about the matter has been put to rest.

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[47] The Commissioner proposed, but did not promulgate, an amendment to the regulations which would modify the rule relating to the redemption of all the stock of a particular shareholder where such shareholder is closely related to the remaining shareholders. The Interpretative Division of the Chief Counsel's Office proposed to rule unfavorably on a transaction involving a redemption from a mother and two daughters, leaving two sons in control. Stephen T. Dean, "The New Section 115(g) Regulations," *Proceedings of New York University Eleventh Annual Institute on Federal Taxation*, page 610. New York: Matthew Bender and Company, 1953.

[48] The Commissioner has been successful in a husband-wife situation that lacked business purpose. *William H. Grimditch*, 37 B.T.A. 402 (1938). Where, however, there was a bona fide purpose to liquidate stockholders' indebtedness, the Commissioner lost despite what was tantamount to a husband-wife situation, the Tax Court stating: "The ownership of stock in a corporation vests in the individual who owns it, not the family to which he belongs. The regulation relates to 'the stock of a particular shareholder,' not that of a family. Besides, the question here is not what effect the transactions had as to the proportionate ownership of the stock, but rather whether the proceeds from the transactions were distributed pro rata among all of the shareholders." *Ira F. Searle Est.*, par. 50,261, Prentice-Hall Memorandum T.C. (1950). In brother-sister and, apparently, in parent-child situations, where other favorable factors were present, the taxpayers have been victorious. *Rosemary Case Weir Trust*, par. 52,199 Prentice-Hall Memorandum T.C. (1952); *Daisy Seide*, 18 T.C. 502 (1952); *Marie W. F. Nugent-Head Trust*, 17 T.C. 817, 823 (1951) (acq.), in which it was stated, "There is no such relationship between plaintiffs and any common stockholder which would be equivalent to one economic unit."

[49] *Albert G. Rooks*, par. 53,036 Prentice-Hall Memorandum T.C. (1953). *Cf. Clarence R. O'Brion*, par. 51,373 Prentice-Hall Memorandum T.C. (1952).

If the two transactions (regardless of the order in which they occur) are viewed as parts of a single integrated transaction, the stockholder has certainly divested himself of his entire interest in the corporation and, so far as he is concerned, there has been a complete liquidation of his interest. It may, therefore, be reasonably contended that the proceeds of the corporate redemption, even though it occurs just ahead of the sale of the remaining stock to the individuals, should not be considered as an ordinary dividend. The alternative courses have the same "net effect" and should receive the same tax treatment if substance is to control. However, in transactions of this nature, it is manifestly advisable to make the sale to the corporation after the sale to the individuals, because the taxpayer's position will then be technically stronger.

b. Personal commitment to purchase stock redeemed. Another situation sometimes arising presents this picture in varying shades: The corporation has two stockholders, one of whom wants to dispose of his entire interest. The other stockholder may not have, or want to put up, the money needed to purchase the stock of the shareholder desiring to retire, and in order to consummate the deal it may be necessary for the corporation to purchase the stock. In such a case, it is important that the shareholder make no personal commitment regarding the purchase, and that the record clearly show that the corporation—not the shareholder—is negotiating for the purchase of the stock. Otherwise, payment by the corporation to the seller will probably be treated as a dividend to the forlorn shareholder who acted before he obtained competent advice.[52]

c. Results to all participating stockholders need not be the same. The structure and provisions of the 1954 Code, as well as the Committee Reports dealing therewith, make it perfectly clear that a distribution may be treated as a dividend to certain participating stockholders and not to others. Under the case law developed prior to the 1954 Code, the same thing was true. Where a corporation had issued preferred stock as a dividend, a part of which was purchased for value by the taxpayer, who owned no common stock, and all the taxpayer's preferred stock was subsequently redeemed, it was held that the proceeds of the redemption did not constitute a dividend to the taxpayer.[53] The Court's conclusion would have been supportable on the ground that all the taxpayer's stock was redeemed and he ceased to be interested in the corporation's affairs,[54] but it was based on the equally firm ground that the proceeds of the redemption could not fairly be regarded as equivalent to a dividend inasmuch as the taxpayer would then be denied the opportunity of recovering his basis.[55]

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[50] Reg. 118, § 39.115(g)-1-(a)(2).

[51] *Zenz* v. *Quinlivan* (D.C., W.D. Ohio 1952) 106 F. Supp. 57, 42 AFTR 461, reversed (6 Cir. 1954) 213 F. 2d 914.

[52] *Wall* v. *United States* (4 Cir. 1947), 164 F. 2d 462, 36 AFTR 42, *Holloway* v. *Commissioner* (6 Cir. 1953), 203 F. 2d 566, 43 AFTR 720; *Mendle Silverman*, T.C. Memo. 1954-62; *Eli R. Lowenthal*, par. 47,169 Prentice-Hall Memorandum T.C. (1947), affirmed (7 Cir. 1948) 169 F. 2d 694, 37 AFTR 233. *Cf. Fox* v. *Harrison* (7 Cir. 1944), 144 F. 2d 521, 33 AFTR 74.

The Court stated that its conclusion would have been different if the taxpayer's stock had been received by him directly from the company as a stock dividend, and that it "may seem somewhat paradoxical" to hold a redemption to be a dividend as to the original recipient of the stock and not as to a purchaser for value from such recipient. Actually, however, there is no real paradox or incongruity involved. Section 115(g)(1) of the 1939 Code was designed as a brake to prevent tax evasion. It is aimed not at the corporation but at the stockholders, requiring them to pay a tax at the regular rate on the money or property distributed to them which is in essence a dividend, although not so labelled. As previously pointed out, a dividend has well defined consequences as to both the corporation and its stockholders, and in order to determine whether a distribution is essentially equivalent to a dividend its effect upon both must be considered. There is, accordingly, no incongruity involved in treating a distribution as the equivalent of a dividend to one stockholder whose proportionate interest in the corporation remains substantially the same, and not to another stockholder whose interest is materially changed or completely eliminated.[56]

Under certain circumstances, perhaps only a portion of a distribution received by a stockholder should be deemed and treated as a dividend. The Commissioner himself has treated the redemption of preferred shares acquired by a taxpayer at the time of corporate organization as a dividend, while refraining from taxing as a dividend the proceeds of the simultaneous redemption of other preferred shares purchased by the taxpayer for value from other stockholders.[57]

7. Redemptions in Partial Liquidation

Under the 1939 Code, the ratable partial redemption having the best chance of qualifying for capital gain treatment was one occasioned by a substantial contraction of the corporation's business.[58] In substance, the law seems to remain the same under the 1954 Code. However, redemptions of that nature are therein viewed from the corporate level and are dealt with in a separate section[59] from those redemptions which, when viewed from a shareholder standpoint, are in reality sales in the economic sense.[60]

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[53] *Parker* v. *United States* (7 Cir. 1937), 88 F. 2d 907, 19 AFTR 215. *Cf. Commissioner* v. *Cordingley* (1 Cir. 1935), 78 F. 2d 118, 16 AFTR 318.

[54] See Section 6, above. The fact that the taxpayer owned no common stock is also an important element; it was so recognized by the Commissioner in *Daisy Seide*, 18 T.C. 502 (1952). See, also, *Marie W. F. Nugent-Head Trust*, 17 T.C. 817 (1951)(acq.); *Penfield* v. *Davis* (D.C., Ala. 1952) 105 F. Supp. 292, 42 AFTR 115, affirmed (5 Cir. 1953) 205 F. 2d 798, 44 AFTR 151. As to the situation where preferred stock was redeemed from one owning no common stock but whose family owned common stock, see Footnote 53, above, and *De Nobili Cigar Co.*, 1 T.C. 673 (1943), affirmed (2 Cir. 1944) 143 F. 2d 436, 32 AFTR 989.

[55] On the basis question, see also *Marie W. F. Nugent-Head Trust*, 17 T.C. 817 (1951)(acq.).

[56] Such was the result in the companion cases, *Boyle* v. *Commissioner* (3 Cir. 1951), 187 F. 2d 557, 40 AFTR 308, cert. den. 342 U.S. 817 (1950), and *Carter Tiffany*, 16 T.C. 1443 (1951)(nonacq.).

[57] *Stein* v. *U.S.* (Ct. Cl. 1945), 62 F. Supp. 568, 34 AFTR 455. Compare *De Nobili Cigar Co.*, 1 T.C. 673 (1943), affirmed (2 Cir. 1944) 143 F. 2d 436, 32 AFTR 989, where some of the taxpayers failed to sustain the burden of proving that they were purchasers for value.

It is apparently intended that the partial liquidation provisions of 1954 Code shall apply only to cases involving a substantial contraction of the corporation's business.[61] A partial liquidation is therein defined as either (1) a distribution constituting one of a series of distributions, in redemption of all the stock of a corporation pursuant to a plan;[62] or (2) a distribution which is not essentially equivalent to a dividend, is in redemption of a part of the corporation's stock, is made pursuant to a plan and occurs within the taxable year in which the plan is adopted, or within the succeeding taxable year.[63] This definition is substantially the same as it was in the prior law.

If a distribution to a shareholder qualifies for capital gain treatment under the provisions of Section 302 of the 1954 Code above discussed (such as one resulting in a substantially disproportionate redemption or in a termination of the shareholder's interest) and also qualifies as a distribution in partial liquidation because of a corporate contraction, then any restriction which might be imposed against the shareholder under Section 302 shall not apply to such shareholder.[64] Accordingly, if a shareholder's interest in a corporation were completely terminated in a transaction qualifying as a partial liquidation by reason of corporate contraction, and his son owned the remaining stock in the corporation, he would not be subject to any sanction if he reacquired an interest in the corporation within ten years after the liquidation.

The 1954 Code describes one type of distribution which will be considered as being in partial liquidation. In order to fit the description, it is necessary that the distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business; that immediately thereafter the corporation is actively engaged in the conduct of a trade or business; that both the terminated trade or business and the continuing trade or business have been actively conducted throughout the five year period immediately before the distribution; and that neither of such trades or businesses was acquired by the distributing corporation in a taxable transaction during the preceding five year period.[65] The description is so narrow that many genuine partial liquidations occasioned by substantial business contractions will probably not qualify thereunder. However, it is expressly provided that partial liquidations include, but are not limited to, those which fit the description.[66]

Although the new law requires that the redemption be made pursuant to a plan, it does not define a plan. The House Bill contained a precise definition which was not embodied in the 1954 Code,[67] and it appears, therefore, that case law arising under the 1939 Code is still applicable. Accordingly, there need not be a formal "plan," but there must exist a purpose to liquidate, clearly evidenced by the records and the surrounding facts and circumstances.[68]

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[58] See cases cited in footnote 21, above.

[59] In the 1954 Code a partial liquidation is defined in § 346, and tax effect on the shareholder is set out in § 331.

[60] 1954 IRC § 302.

[61] Sen. Rep. p. 262.

[62] 1954 IRC § 346(a)(1). *Cf.* 1939 IRC § 115(i).

[63] 1954 IRC § 346(a)(2). *Cf.* 1939 IRC §§ 115(i) and 115(g)(1).

[64] 1954 IRC § 346(c).

[65] 1954 IRC § 346(b).

[66] 1954 IRC § 346(a)(2).

If the partial liquidation does not fit the description in Section 346(b) of the 1954 Code, it is wise to assume that the terminated business must constitute a substantial part of the distributing corporation's total business. In doubtful cases, it will, therefore, be helpful if the distribution can find shelter under the tent of a redemption which is either substantially disproportionate or in termination of the shareholder's interest.

While the 1954 Code materially changes the structure of the law respecting partial redemptions, the substance of the law remains largely as it was. Under prior law there was but one basic inquiry, which was whether a distribution in redemption was essentially equivalent to the distribution of a taxable dividend. Under the 1954 Code, that general test remains, but in its application some specific tests and rules have been provided which will contract the pre-existing area of uncertainty.

8. The Redemption of Stock of a Decedent's Estate

In the administration of estates a troublesome problem frequently arises because of the lack of liquidity. How can the estate of a deceased stockholder acquire funds needed to pay death taxes, debts and expenses? At least a partial solution of the problem may be found in Section 303 of the 1954 Code, which corresponds to and liberalizes Section 115(g)(3) of the 1939 Code.

A distribution by a corporation, within the time prescribed in the statute, in redemption of stock of a decedent's estate will be accorded capital gain treatment, if the entire amount of such corporation's stock included in the decedent's estate constitutes more than 35 per cent of the value of the gross estate, or more than 50 per cent of the value of the taxable estate.[69] Such a distribution will qualify, however, only to the extent of the total of (1) the death taxes, including interest thereon, imposed because of the decedent's death, and (2) the amount of funeral and administration expenses allowable as deductions for Federal estate tax purposes.[70]

The stock of two or more corporations is treated as the stock of one corporation if more than 75 per cent in value of the outstanding stock of each corporation is included in the decedent's gross estate. For the purpose of the 75 per cent requirement, stock which represents the surviving spouse's interest in community property is treated as having been included in the decedent's estate.[71]

If new stock is received by an estate as a stock dividend on, or in a non-taxable exchange for, stock acquired from the decedent, a redemption of the new stock will qualify to the same extent that a redemption of the stock acquired from the decedent would have qualified.[72]

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[67] H.R. 8300, § 336(c). See also, House Rep., p. A111.

[68] Mertens, Jacob, Jr., *Law of Federal Income Taxation*, Vol. 1, chapter 9. Chicago: Callaghan and Company, 1942.

[69] 1954 IRC §§ 303(b)(2)(A)(i) and (ii).

[70] 1954 IRC § 303(a)(1) and (2).

[71] 1954 IRC § 303(b)(2)(B).

Of course, even if the redemption of stock of the decedent's estate does not qualify for capital gain treatment under Section 303, it will still do so under the Code provisions previously discussed, if it (1) is not essentially equivalent to a dividend, or (2) is a substantially disproportionate redemption, or (3) effects a complete termination of the shareholder's interest, or (4) is in complete or partial liquidation of the corporation.[73]

9. Complete Liquidation

Under both the 1939 and 1954 Codes, amounts distributed in complete liquidation of a corporation are treated in the same manner as the proceeds of the sale of the stock.[74]

A complete liquidation contemplates a winding up of the corporation's business and a complete distribution of its assets. Although the retention by the corporation of only enough assets to cover its debts, or the failure to dissolve the corporation under State law, will probably not disqualify the transaction as a complete liquidation,[75] it is manifestly advisable to avoid any loose ends by distributing all the corporation's assets and by effecting its dissolution. The complete liquidation is ordinarily an absolutely safe vehicle to use in conveying the corporation's assets to its stockholders at the bargain rates applicable to capital gains, but in certain situations there may be hazards involved which should not be overlooked.

For example, where a corporation is completely liquidated, and its stockholders keep certain of the distributed assets and transfer the others to a new corporation, in exchange for its stock, on a ratable basis, two contentions may be advanced: (1) that the liquidation was not in good faith;[76] and (2) that what occurred was in reality a reorganization.[77] Accordingly, the retained assets may be deemed taxable as ordinary income.[78]

The critical question seems to be whether at the time of liquidation there was any plan to reincorporate, so that the two acts should be viewed as part of a single integrated transaction. The length of time between the two is an important evidentiary consideration. Where nine months had elapsed between the dissolution of the old corporation and the formation of the new one, and there was other evidence of separate and independent transactions, it was held that no reorganization occurred.[79] The House of Representatives proposed in its bill that the 1954 Code contain a provision dealing with transactions of this type.[80] However, it was not retained by the Senate because of the technical problems involved and because the possibility of tax avoidance in this area was not considered sufficiently serious to require a special statutory provision. The Senate felt "that this possibility can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill."[81]

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[72] 1954 IRC § 303(c).

[73] Or, if it is a stock issued by a railroad corporation within the provisions of 1954 IRC § 302(b)(4).

[74] 1954 IRC § 331(a)(1); 1939 IRC 115(c).

[75] *Kennemer* v. *Commissioner* (5 Cir. 1938), 96 F. 2d 177, 21 AFTR 103.

[76] Reg. 118, § 39.115(g)-1-(a)(2).

[77] *E.g.* 1954 IRC § 368(a)(1)(D); 1939 IRC § 112(g)(1)(D).

[78] As a dividend: 1954 IRC § 301(c)(1); 1939 IRC § 115(g)(1); or as "boot" distributed in connection with a reorganization: 1954 IRC § 356(a)(2), 1939 IRC § 112(c)(2). See, also, *Survaunt* v. *Commissioner* (8 Cir. 1947), 162 F. 2d 753, 35 AFTR 1557. If, in such a case, the stockholders' interests in the new corporation were so changed that the transaction would not come within the terms of the reorganization sections, the danger of such an attack would be avoided.

A serious hazard also exists, if shortly prior to a complete liquidation and in contemplation thereof a reorganization occurs. For example, where a corporation sold two of its three businesses and, in order to avoid exposure of the proceeds thereof to the risks of the remaining business (which could not be sold), transferred the assets of the remaining business to a newly formed corporation in exchange for its stock and then completely liquidated, it was held that the property received by the stockholders, other than the stock in the new company, was taxable as ordinary income.[82] It would seem that in cases of this nature a genuine partial, if not complete, liquidation of the corporation is effected, but in the light of the past decisions the need for extreme caution in this area appears obvious.[83]

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[79] *Charles R. Mathis, Jr.*, 19 T.C. 1123 (1953). See, also, *U.S.* v. *The Arcade Company* (6 Cir. 1953), 203 F. 2d 230, 43 AFTR 652.

[80] H. R. 8300, § 357.

[81] Conf. Rep., p. 41.

[82] *Lewis* v. *Commissioner* (1 Cir. 1949), 176 F. 2d 646, 38 AFTR 377; *William M. Liddon*, 22 T.C. 1220 (1954). *Cf. Ernest F. Becher*, 22 T.C. 932 (1954).

[83] The following related subjects are not discussed in this Chapter: Distributions by a subsidiary to a parent in complete liquidation of the subsidiary: 1954 IRC § 332; 1939 IRC § 112(b)(6). Distributions in complete liquidation of a corporation effected within a single calendar month; 1954 IRC § 333; 1939 IRC § 112(b)(7). Redemptions of bail-out preferred stock: 1954 IRC § 306. Distributions in partial or complete liquidation of a collapsible corporation: 1954 IRC § 341; 1939 IRC § 117(m). Distributions in partial or complete liquidation of certain foreign personal holding companies: 1954 IRC § 342; 1939 IRC § 115(c).

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The Expansion and Contraction of Corporate Operations: How to Buy Out a Stockholder

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1. Points to Consider

The inevitable shifting of corporate interests among stockholders of close corporations can be accomplished with minimum capital gains tax burdens or subject to the more burdensome ordinary income rates. The determination of which result to expect involves a consideration of the following:

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2. General Nature of the Problem

The tax problems in buying out a co-stockholder would appear at first blush to be most simple, involving only the application of the capital gains provisions of the Internal Revenue Code. However, as is true of so many problems, what at first look appears simple becomes more complex when carefully scrutinized. Especially is this true in the case of the so-called "close corporation"[1] which is the subject of our consideration here, and which is to be distinguished from the publicly owned corporation.

These complexities arise not only from the intricacies of the tax law, confusing as they may be in themselves,[2] but stem basically from the inherent nature of the "close corporation" and from the fact that for tax and other purposes as well the close corporation is in effect a hybrid—neither fish nor fowl—which is in form a corporation, but in fact operated more like a partnership. Further complexities arise from the varying distinctions drawn between the close corporation and the large publicly owned corporation.[3]

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[1] "Things are not always what they seem."—Phaedrus, 8 AD, Book iv, Fable 2, 5. A "close corporation" has been defined as one "wherein all the outstanding stock (there being no publicly held securities of any other class) is owned by a small number of persons who are personally active in the management of the business." Rohrlich, *Organizing Corporate and Other Business Enterprises* (1949 ed.), § 4.19. It is stated further by the same author that the primary attribute is not in the size of the business or the number of its shareholders, but in the identity between ownership and active management (*Idem*, § 3.19, n. 10), as in the case of the partnership. *Cf. Commissioner* v. *Tower*, 327 U.S. 280, 286-7, 290.

It is primarily for these reasons that it is difficult to find consistency in the cases, and each case must in the last analysis stand upon its own particular and usually peculiar facts.[4] However, bearing these factors in mind, we can break our particular problem down in such a fashion as to give us soundings and bearings with which to chart our own course as each particular situation arises.

Let us, then, proceed with our consideration of the problem at hand by dividing it into two parts: I. The problem pertaining to the buying out of a stockholder by the corporation; and II. The problems pertaining to the buying out of a stockholder by a co-stockholder.

As indicated by the subject, we shall primarily discuss the problem from the viewpoint of the accomplishment of corporate rather than stockholder objectives.[5] Furthermore, it must be borne in mind that we are here concerned with the acquisition by *purchase* of all of a particular stockholder's stock and not with the pro rata acquisition by distribution of assets or otherwise of a part of the stock of all stockholders, as in the case of the usual partial liquidations which may or may not fall within the orbit of 1954 IRC Sec. 302, 336, 346; IRC 1939 Sec. 115(g).[6] Hence, the cases dealing with the latter situation, the usual partial liquidation case, should not be confused with those involving the former transaction, the purchase of all the stock of a particular stockholder. While the two problems are closely related and may even overlap (cf. *Pullman, Inc.*, 8 T.C. 292), they are nevertheless distinct and similarity merely emphasizes the important difference.[7] Failure to appreciate the distinction has led to a good deal of confusion and loose thinking on the problem here under discussion.[8]

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[2] It is accurately stated that the general problem is "one of the most complex and elusive in the tax law," due partly to the "variety of factual elements" and partly to the piecemeal legislative tinkering with § 115, and as further done in the 1954 IRC. Rabkin and Johnson, "Federal Income Gift and Estate Taxation," C. 3, § 7. For an earlier treatment of the subject, see Oliver W. Hammonds, pp. 818-825, *Proceedings of the Eighth Annual Institute on Federal Taxation,* copyright 1950 by New York University. Publisher, Matthew Bender & Company, Inc., New York City.

[3] Rohrlich, *op. cit. supra,* n. 1, § 4.21.

[4] *Cf. Samuel A. Upham,* 4 T.C. 1120 (1945); *Bona Allen, Jr.,* 41 B.T.A. 206, 219 (1940). See also Sec. 302(b)(1) of IRC, 1954.

[5] While it may be in the case of a reorganization of a close corporation that there is no real basis for differentiating between "corporate purpose" and "shareholder purpose" as was stated in the case of *Harriet S. W. Lewis et al., Trustees* v. *Comm'r* (C.C.A. 1st, 1949) 176 F. 2d 646, that certainly should not be true of transactions of the kind here being considered. *Harry A. Koch,* 26 B.T.A. 1025 (1932); *Clara Louise Flinn,* 37 B.T.A. 1085, 1094 (1938); *Bona Allen, Jr.,* 41 B.T.A. 206 (1941); *Fred B. Snite,* 10 T.C. 523, 532 (1948) no acq. aff'd. *Comm'r* v. *Snite,* 177 F. 2d 819 (C.C.A. 7th, 1949); *Comm'r* v. *John T. Roberts* (C.C.A. 4th, 1953) 203 F. 2d 304; cf. *Samuel A. Upham,* 4 T.C. 1120; *Rheinstrom* v. *Conner* (C.C.A. 6th, 1942) 125 F. 2d 790, 796. But *cf. Pullman, Inc.,* 8 T.C. 292, 298 (1947); *Kirschenbaum* v. *Comm'r,* 155 F. 2d 23, 24 (C.C.A. 2d, 1946).

It has been suggested that the showing of a corporate as distinguished from business purpose is required only where the issue is as to the purchase of part rather than all of a stockholder's stock (Miller, "Stock Redemptions," *Proc. N.Y.U. Sixth Ann. Inst. on Fed. Taxation,* 307, at 313), and that such showing is unnecessary in the latter case. Even if this should be the rule, it is clearly desirable to have a showing of corporate rather than stockholder purpose in the latter case also in terms of 1954 IRC § 302; 1939 IRC § 115(g), particularly if the corporation is owned by only a single stockholder rather than several. *Cf. Harry A. Koch,* 26 B.T.A. 1025 (1932). See also *Fred B. Snite, supra.*

[6] Reg. 118, § 39.115(g)-1. See *Georgia P. Johnson et al.,* 6 C.C.H. T.C. Memo., Dec., p. 633, at p. 641 (1947); *Estate of Charles D. Chandler,* 22 T.C. No. 142 (1954). But cf. Reg. 118, § 39.115(c)-1; *Jeffries* v. *Comm'r,* 158 F. 2d 225 (C.C.A. 5th, 1946). See also *Comm'r* v.

The point is, as clearly emphasized in Sections 39.115(a)-1, 39.115(c)-1, and 39.115(g)-1 of the Regulations,[9] that there are at least three related but nevertheless separate and distinct problems which may be presented by a particular stock transaction, and which are to be distinguished taxwise:

1. A strict stock purchase of all the stock of a particular stockholder, a transaction of the kind we are here considering, as, for instance, in the case of *Fred B. Snite.*[10]
2. A partial liquidation involving the acquisition and cancellation of all the stock of one of several stockholders by distribution in kind, as found in the case of *Lucius Pitkin, Inc.*[11] This should be distinguished from the pro rata cancellation or redemption of a part of the stock of all the stockholders as is indicated in Section 39.115(g)-1 [12] and Section 331, IRC, 1954.
3. A dividend under Sec. 115(g), as, for instance, in the case of *Hyman* v. *Helvering.*[13]

Germane to all the foregoing is, of course, Sec. 302 of the IRC, 1954, pertaining to the tax treatment of stock redemptions, which was the subject of Section 115(g) of the 1939 Code. The distinctions and relationships of the foregoing

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John T. Roberts, footnote 5 above. See generally, Blum, "When is a Partial Liquidation Taxable as a Dividend," *1951 Major Tax Problems*, University of So. California School of Law Tax Institute, p. 195.

[7] See *Lucius Pitkin, Inc.*, 13 T.C. 547, decided October 11, 1949.

[8] Cf. *Pullman, Inc., supra*, n. 5, where the transaction in form purported to be a purchase of part of the stock of the single stockholder and also partook of the nature of the usual partial liquidation because it involved only a part of his stock, and the court was hazy in drawing the distinction between the two different kinds of transactions, but nevertheless indicated (p. 297) that had there been a corporate business purpose and a bona fide purchase transaction there would have been a capital transaction rather than a dividend. Cf. also *Hyman* v. *Helvering* (CCA, D.C., 1934) 71 F. 2d 342, for a similar situation where only a single stockholder owned the corporation. Such cases involving a single stockholder admittedly are nearer 1954 IRC § 302; 1939 IRC § 115(g), than where there are several stockholders, for the reasons indicated at p. 344 of the last cited case. Of course, had all the stock of the sole stockholder in the *Pullman* and *Hyman* cases been acquired rather than a part, the question would then be one of complete liquidation in relation to 1954 IRC § 302; 1939 IRC § 115(g), rather than partial liquidation.

[9] See and compare also Reg. 118, § 39.22(a)-15 with 39.22(a)-20.

[10] 10 T.C. 523 (1948) non. acq. *Cf. James F. Boyle* v. *Comm'r* (C.A. 3rd, 1951), 187 F. 2d 557. For the distinction between liquidation and purchase, see *Merten's Law of Federal Income Taxation*, sec. 9.98. See also *W. C. Robinson*, 42 B.T.A. 725 (1940).

[11] 13 T.C. 547 (1949). This transaction involved corporate tax liability and was undertaken for stockholder rather than corporate purposes. The Commissioner contended, under § 29.22(a)-15 of the then Regulation that the transaction was a partial liquidation rather than a loss under the then § 29.22(a)-15, as contended by the taxpayer.

[12] See *Comm'r* v. *John T. Roberts*, footnote 5, above. But cf. *L. B. Coley*, 45 B.T.A. 405, 415 (1941), app. dismissed C.C.A. 5th, where the court stated that it was not necessary to have a liquidation of every stockholder in order to have a *pro rata* liquidation.

[13] 71 F. 2d 342 (C.C.A. D.C., 1934).

in relation to redemptions are not entirely clarified by IRC 1954, although a brave start thereon is made. The factual problems remain.[14]

3. The Problems Pertaining to the Buying Out of a Stockholder's Stock by the Corporation

The most effective manner to consider the problems pertaining to the purchase of a stockholder's stock by the corporation is to look first at the corporate tax position and objectives and then at the stockholder's tax position and objectives, bearing in mind that there may or may not be a conflict between the tax position and objectives of the corporation and the stockholder, and that the extent and nature thereof will in large part determine the purchase price of the stock to the corporation, and, in fact, whether the transaction can even be effected in a practical matter.[15]

a. The corporate tax position and objectives. The corporate objective in the purchase of its own stock from one of its stockholders may be either the contraction or expansion of its operations. It may be motivated by such legitimate corporate business reasons as financial requirements,[16] employee benefits[17] and the like.[18] As pointed out above,[19] these are to be contrasted and distinguished from the stockholder's purposes and objectives such as the securing of cash from the corporation.[20]

A primary corporate tax requisite in the purchase of its own stock will of course be to buy the stock without gain to it and in such a manner as to provide a maximum flexibility therewith for its future operations. Whether gain (or loss) will be realized by the corporation from the purchase of its stock will depend upon the nature of the purchase transactions, the consideration paid therefor, and the subsequent disposition of the stock by the corporation.[21]

It appears that the ordinary purchase of its stock by a corporation with cash followed by retirement of the stock will be treated as a capital transaction with no gain or loss realized by the corporation.[22] Where, however, the stock is purchased with corporate property rather than cash it may be a purchase, or it may, on the other hand, be a sale of corporate assets, a liquidating distribution, or a non-taxable exchange. If the transaction is in fact a sale of corporate assets rather than a purchase of stock, gain or loss is realized by the corporation to the extent that the value of the stock exceeds or is less than the cost basis of the assets surrendered for the stock.[23] If the transaction partakes of the nature of a liquidating distribution, then the Regulations indicate that no gain or loss is to be realized by the corporation upon the acquisition of its stock in connection therewith.[24] This last rule is now codified in Sec. 336 of IRC 1954.

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[14] See generally, Wilson, "Stock Redemptions as Dividends," 1954, *Taxes,* 718. See also Kaufman, "How to Treat Stock Redemptions," 9 *N.Y.U. Tax Inst.*, 1007.

[15] See Research Institute Policy Memorandum dated March 7, 1949: "What's Your Business Really Worth?"

[16] *Harry A. Koch,* 26 B.T.A. 1025 (1932).

[17] *Fred B. Snite, supra,* note 5. *Samuel A. Upham,* 4 T.C. 1120 (1945).

[18] *Joseph W. Imler,* 11 T.C. 836 (1949). The promotion of harmony in the conduct of a business is a proper business purpose. *Gazette Pub. Co.* v. *Self,* 103 F. Supp. 779 (D.C. Ark. 1952), at p. 784. Dominant motivation is, of course, a factual determination.

[19] Footnote 5, *supra.*

[20] *Pullman, Inc.*, 8 T.C. 292 (1947).

[21] Reg. 118, § 39.22(a)-15. Cf. § 39.22(a)-20. See also *Lucius Pitkin, Inc.*, 13 T.C. 547. See also Secs. 336 and 1032 of IRC, 1954, indicating no tax will be imposed on the corporation.

[22] *First Chrold Corporation* v. *Comm'r,* 97 F. 2d (C.C.A. 3rd, 1938), rev'd 306 U.S. 117 on other issues. See also *Hutchins Lumber & Storage Co.*, 4 B.T.A. 705, 711 (1926). But *cf. Lucius Pitkin, Inc., supra,* note 20. *Quaere* if retirement is material at this point. Cf. no. 26 *supra.* See also Rev. Rul. 54-408, I.R.B. No. 39, 9/27/54, at p. 8. Clearly retirement is not required under Sec. 317(b) of IRC, 1954 in the case of "acquisition" by "redemption."

In the event, of course, that the corporation buys in its stock and does not retire it, but holds it as Treasury stock and later sells it, then, at that time, we get into the area of an entirely different but related problem pertaining to the realization of gain by the corporation at the time of the subsequent disposition of the stock, as distinguished from the original acquisition thereof.[25] Suffice it to say that notwithstanding the varying factual distinctions developed in the Regulations[26] and the present conflict in the decisions of the courts, it was a hardy corporate taxpayer who would voluntarily invite trouble in this respect and risk a gain when the problem could rather easily be avoided by the retirement of such stock as the corporation had bought in and, if necessary, the use of previously issued or newly issued stock for the subsequent sale.[27] This problem now appears to be clarified by Secs. 317(b) and 1032 of the IRC, 1954, so that no gain will be realized by the corporation in any event in these circumstances.

b. The stockholder's tax position and objectives. Most generally the stockholder will be interested in making a sale of his stock to his corporation for the purpose of obtaining cash; the corporation being very frequently the most desirable and, likely, and, in most cases, the only market he has for that purpose. The tax considerations involved in the accomplishment of this particular objective have been discussed elsewhere[28] and will not, therefore, be further considered here except to point out that 1954 IRC Sec. 302; 1939 IRC Sec. 115(g) is a flashing red light for the wary.

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[23] *Burnet* v. *Commonwealth Improvement Co.*, 287 U.S. 415; *Allyne-Zerk Co.* v. *Commissioner*, 83 F. 2d 525 (C.C.A. 6th, 1936).

[24] See Reg. 118, § 39.22(a)-15 and § 39.22(a)-20. See also *Lucius Pitkin, Inc.*, 13 T.C. 547 (1949). But cf. *J. T. S. Brown's Son Co.*, 10 T.C. 840 (1948) acq. 1948-2 C.B.

[25] See *Lucius Pitkin, Inc., supra; cf. Burrus Mills, Inc.*, 22 T.C. No. 107. See also Anderson, "Gain or Loss to a Corporation Dealing in its Own Shares," 1953 *Major Tax Problems, Univ. So. Cal. School of Law Tax Institute Proceedings*, p. 121. For a discussion of another related problem, the impact of Sec. 102 of the Internal Revenue Code upon the corporate tax picture, see Harnett, "Buying Out the Disputatious Shareholder," *Proceedings of New York University Eleventh Annual Institute on Federal Taxation*, page 393, at p. 403.

[26] Reg. 118, § 39.22(a)-15.

[27] See generally Fager, "Watch Out for Treasury Stock," 1949 *Taxes* p. 719; Smith, "Gains Derived From the Sale of Treasury Stock," *Proc. N.Y.U. Seventh Ann. Inst. on Fed. Taxation*, p. 582. See also note 62 Harv. L. Rev. 1074, and *Comm'r* v. *Landers Corp.*, 210 F. 2d 188 (CA-6, 1954). Note however, that what the corporation does with the stock may have a bearing upon whether there is a sale or partial liquidation. Compare *Alpers* v. *Comm'r*, 126 F. 2d 58 (C.C.A. 2nd, 1942) with *Kirschenbaum* v. *Comm'r*, 155 F. 2d 23 (C.C.A. 2d, 1946). See also William A. Smith, 38 B.T.A. 317 (acq.); *Andrews*, C.C.H., B.T.A. memo. op., Dec. 10, 794-G. Perhaps, as suggested in the latter case, the premium is not upon what the corporation does but upon which forum the taxpayer proceeds in. See also Ray and Hammonds, "Federal Income Tax Treatment of Oil Payments: The Validity of G.C.M. 24849," 25 *Texas L. Rev.* 121, at p. 124. The potential variables of course make the fascination and complexities of the problem increase in direct proportion thereto. See Sec. 317(b) of the IRC 1954 as a clarifying step in relation to Treasury stock.

[28] Harnett, "Buying Out the Disputatious Shareholder," *11 N.Y.U. Inst. on Fed. Taxation*, 392. Miller, "Stock Redemptions," *Proc. N.Y.U. Sixth Ann. Inst. on Federal Taxation.* See *Clarence R. O'Brion*, 10 TCM 1122, and compare with *James F. Boyle* v. *Comm'r* (CAA-3,

In dealing with the corporation,[29] the stockholder will most generally be primarily interested and concerned in ascertaining whether any gain realized from the transaction will be treated as capital gain rather than as a dividend. The authorities support the proposition that where the purchase involves the acquisition of all,[30] as opposed to part, of a particular stockholder's stock and the purchase is made for corporate rather than stockholder purposes,[31] it may be treated as either a purchase of the stock[32] by the corporation or a partial liquidation,[33] rather than a dividend under Internal Revenue Code 1954 Sec. 302; 1939 IRC Sec. 115(g). In either event capital gain is realized by the stockholder.[34] This rule is further codified in Sec. 302 of IRC, 1954.

4. The Problems Pertaining to the Buying Out of a Stockholder by a Co-Stockholder

The first and perhaps most ordinary situation to be discussed in considering the purchase of all the stock of a co-stockholder is where one or more of the other stockholders of the corporation undertake to buy such stock from their own funds completely independent of and apart from the corporation. In such a transaction, there would appear to be no basis for treating the purchase as

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1951), 187 F. 2d 557, and discussion thereof at par. D-554a and D-555b of R.I.A. Fed. Tax Coordinator, Supplement 1953 May ed. See also *P.H. Tax Ideas Report,* Vol. 1, No. 2, 5/29/53, par. 7003.6. See also J. K. Lasser *Report on Taxes* 1/15/52. See also "Recommendation III, Taxation of Distributions From Corporations to Decedents' Estates Where Funds Are Required to Pay Taxes, etc." *Report of the Committee on Federal Income Taxes,* Section of Taxation, American Bar Association at tenth annual meeting of the section at St. Louis, Missouri, which recommendation was given the approval of the section of Taxation at that meeting, and culminated in the Revenue Act of 1950 as Section 115(g)(3) of the 1939 Internal Revenue Code; 1954 IRC Sec. 303. See Aarons, Redemption of Stock to Pay Death Taxes, 4. *U. Cal. Law School Tax Inst.,* 1952, p. 253.

[29] A sale to a wholly owned subsidiary is not regarded as a sale to the corporation and this route presents an opportunity for solving the problem simply to the taxpayer's advantage. *Rodman Wanamaker Trust,* 11 T.C. 365 (1948). But *cf. Comm'r* v. *Transport Trading and Terminal Corp.,* 176 F. 2d 570 (C.C.A. 2d, 1949) involving sale to parent. Secs. 304 and 306 of the 1954 IRC must now also be considered in such situations.

[30] Where a stockholder owns common plus preferred stock plus debentures, to qualify within the Regulations as a purchase of all of his stock all these interests should be acquired from the stockholder (Mertens, *Law of Federal Income Taxation,* 1942. Vol. 3, § 20.60, p. 229) although promissory notes of the corporation could presumably be left with the stockholder or furnished to him as part of the consideration. Mertens, *supra,* § 11.79. See also Miller, "Stock Redemptions," *supra,* note 27.

[31] But *cf. Lucius Pitkin, Inc.,* 13 T.C. 547 (1949) where stockholder purposes were involved. It is not intended to state or imply that the factors referred to are the sole considerations and requirements to the exclusion of others, but merely that they are the principal and controlling ones. *Clara Louis Flinn,* 37 B.T.A. 1085, 1094. See also *Keefe* v. *Cote,* — F. 2d — (CA-1, 1954).

[32] *Clara Louise Flinn,* 37 B.T.A. 1085 (1938).

[33] *Lucius Pitkin, Inc.,* 13 T.C. 547 (1949); *Bona Allen, Jr.,* 41 B.T.A. 206 (1940). See also Rev. Rul. 54-408, I.R.B. No. 39, 9/27/54, at p. 8.

[34] Section 115(c)(i) IRC; Reg. 118, § 39.115(g)-1. However, a purchase price appreciably in excess of the fair market value of the stock might well be treated as a dividend to the extent at least of the excess. *I. S. Godley,* 19 T.C. 1082. Cf. *Limericks, Inc.,* 7 T.C. 1129 (1946), aff'd 165 F. 2d 483 (CCA-5, 1948).

other than an outright capital gain transaction as between the purchaser and seller.

A variation of the foregoing may be presented where there is a combination sale of a part of the stockholder's stock to another stockholder or stockholders and the purchase or redemption of the remainder by the corporation. It has been stated that there is also no problem here and that the redemption or purchase of the remainder of the stock by the corporation would qualify as a partial liquidation, the consideration paid therefor by the corporation not being taxable as a dividend.[35] Where, however, the part of the stock initially acquired by the other stockholders is subsequently redeemed or acquired from them by the corporation then this may constitute an ordinary dividend to them,[36] and it may be that the initial transaction between the selling stockholder and the corporation will be examined retroactively, especially if agency in behalf of the corporation was indicated.[37]

The preceding discussion has already pointed up the seller's tax position in a sale of his stock to his co-stockholders. While he may ordinarily expect a capital gain therefrom he may, under certain circumstances as indicated, fare differently and both he, and even his purchasers, be held to have received an ordinary dividend or perhaps a liquidating dividend.

In addition to being aware of the above discussed advantages as well as pitfalls in his tax position the seller may also wish to secure a still better tax position for himself by the deferment of gain. There are several different ways by which he may do this.[38] First, he may effect an installment sale within 1954 IRC Sec. 453; Sec. 44 IRC 1939 and thereby spread his gain over several years, thus achieving possible lower surtax rates or utilizing possible offsetting capital losses which may be available in those later years. The seller may also improve his tax position by use of a "deferred payment sale" rather than an installment sale, and thereby spread his receipts ratably over successive years. Finally, the seller may effect an option payment and thereby also defer or postpone the date of taxation of the price received for his stock.

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[35] Miller, "Stock Redemptions," *supra* note 27, at p. 332. See also *Zenz* v. *Quinlivan*, 213 F. 2d 914 (CA-6, 1954).

[36] *E. R. Lowenthal*, T.C. memo., July 1947, aff'd. 169 F. 2d 694 (C.C.A. 7th, 1948); *cf. Fox* v. *Harrison*, 145 F. 2d 521 (C.C.A. 7th, 1944). See also *Wall* v. *United States*, 164 F. 2d 462 (C.C.A. 4th, 1947). See generally, Harnett, "Buying Out of the Disputatious Shareholder," *11 N.Y.U. Int. on Fed. Tax.*, 392.

[37] In other words, the transaction might be regarded by the Treasury as if the entire stock had been initially acquired by the corporation, in which event the various factors and considerations discussed under Part I above would be applicable. *Holloway* v. *Comm'r* (CA-6, 1953), 203 F. 2d 566, decided 4/15/53. See also *Fox* v. *Harrison, supra.* A somewhat related situation, involving a converse variation of the Court holding company principle, might also be presented in a case where, after negotiations between stockholders, the stock was actually bought and paid for by the corporation rather than by the other stockholder, the question then being whether the other stockholder could be considered as the purchaser for tax purposes. See *Smith*, T.C. memo, 495 CCH Sec. 7573(M). See also *Comm'r* v. *Transport Trading and Terminal Corp.*, 176 F. 2d 570 (C.C.A. 2d, 1949). Cf. *Alpers* v. *Comm'r* (C.C.A. 2d, 1942), 126 F. 2d 58. See generally, *Lasser's Business Tax Guide* (1953), p. 253, "How Stockholders in a Closely Held Corporation Should Buy Each Others Securities," and also Nicholson, "Corporate Assistance in Sale of Stock," 1954, *Taxes*, p. 644. Sections 304 and 306 of the 1954 IRC are also of pertinent interest at this point.

[38] See generally for an excellent discussion of the details involved, Jenks, "How to Make Effective Use of Installment and Other Sales Mechanics to Reduce Taxes," *Proc. N.Y.U. Sixth Ann. Inst. on Fed. Taxation* 467. Such methods may be particularly advantageous in the sale of stocks, for instance, between a parent in the high tax bracket and a son in a lower one where the purchase price is secured by the property only or otherwise; the father thus shifts income producing property at capital gains rates to his son or others in a lower tax bracket. This may be beneficial for estate as well as income tax purposes.

Conclusion. This discussion should at least have convinced any "doubters" of the truth of the statement made at the outset that the subject of this article is simple only on the surface. Certainly the problem discussed herein is a recurring one with which every practicing lawyer will be frequently faced in some variation during either the life or death of a stockholder client or with respect to a closely owned corporate client, whether he or it be seller or purchaser. Hence the practical necessity for understanding the pattern of the problems involved and the indicated solutions to some of them. An error can not only be costly, but ignorance can distort and in some cases destroy a desirable transaction because of an unnecessarily high tax burden. The lower the tax cost to the seller, and to the purchaser, the more readily and profitably can the stock in a closely held corporation be purchased, whether the purchaser be the corporation or another stockholder, incident to and as a part of the expansion or contraction of the corporate operations.

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Current Restrictions on Stock Dividends

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The Internal Revenue Code of 1954 has made radical changes in the tax treatment of stock dividends. There is no change, however, in the treatment of cash dividends which are taxable as ordinary income to the extent of the earnings of the current year, and of the accumulated earnings and profits of the corporation after February 28, 1913.[1] Under the 1939 Code, dividends in stock of the declaring corporation were taxable only to the extent that they constituted income within the Sixteenth Amendment of the Constitution of the United States.[2] Under the 1954 Code, however, the distribution of stock dividends and dividends consisting of rights to acquire the stock of a corporation generally are not taxable.[3] The amount realized on the later sale or disposition of a dividend of stock or stock rights, however, is generally treated as ordinary income with certain exceptions.[4]

In this Chapter, we are concerned not only with the factors leading a corporation to declare a stock dividend, but also with the circumstances under which stock dividends and the proceeds thereof may become taxable.

1. Points to Consider

Normally, you should be considering the issuance of a stock dividend only where a corporation has a substantial surplus which is really invested in fixed assets or represents the working capital required for prudent operation of the corporate enterprise. In any case in which a stock dividend is contemplated, the following factors will merit your careful consideration:

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[1] 1954 IRC §§ 301, 316; but see also § 116.

[2] 1939 IRC §§ 115(f)(1), 115(a)(1).

[3] 1954 IRC § 305.

[4] 1954 IRC §§ 306(a), 306(b).

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2. Publicly Held Corporations

Stockholders relationships. In the widely held corporation, the tax effect on stockholders generally plays a small role in the formulation of dividend policy since the considerations are usually financial and economic.[5] A corporation may have a year in which it has large corporate earnings, but large capital outlays, cash requirements for expansion, inventories, and the like, may prevent substantial cash dividend distributions. Of course, the larger the dividend, the less available for corporate purposes. The established dividend policy, however, may make imperative some cash dividends. Reduction of the amount of dividends might result in unfavorable stockholder reaction which sometimes can be obviated by a supplemental stock dividend.

The importance of stockholder relations may be demonstrated by the recent experience of a corporation which sought to increase its fixed capital and was presented with the alternative of a stock dividend or a recapitalization. Its management indicated a preference for the stock dividend, one of the officers stating that "psychologically it is better to use the stock dividend. They think they're getting something."

In another recent experience a major stockholder desiring to achieve a wider distribution of the corporation's stock succeeded in his objective by promoting the idea of a stock dividend, after the receipt of which he placed a large block of stock in the hands of a broker with instructions that not more than ten shares should be sold to any one customer.

Undoubtedly many other considerations shape the dividend policy of the widely held corporation. Tax considerations, however, do not seem to play a large part, even though the stock dividend has been frequently resorted to in recent years by the widely held corporation.[6]

Directors' considerations. In the widely held corporation, if tax factors are given consideration, it may be found that the directors have a personal interest akin to that of the director-stockholder in the closely held corporation. Failure of the directors to declare dividends in this type of situation raises at least two important problems: (1) The possible imposition of the Section 531 surtax even on the widely held corporation;[7] and (2) The possible personal liability of directors of the corporation to the stockholders for alleged mismanagement, bad faith or negligence as a result of the successful assertion of the Section 531 tax.[8]

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[5] See, in general, Robert E. Zang and George C. Thompson, "Why Stock Dividends are Declared," *Taxes*, October, 1949, Vol. 27, page 883.

[6] See Zang and Thompson, footnote 5, above.

The liability of directors does not automatically follow from the payment of the 531 penalty tax by the corporation as a result of the tax litigation. It first becomes incumbent upon the stockholders to bring suit. The use of the tax litigation as an aid to proof of the mismanagement, negligence, or bad faith of the directors in such a case would seem to be affected by the limitations of the doctrine of collateral estoppel;[9] furthermore, the burden of proof in the ordinary legal action is not so favorable to the plaintiff as it is to the Commissioner in the usual tax litigation.[10] While these obstacles must be overcome before the directors may be held liable as a result of the imposition of the Section 531 surtax, the threat of such a liability is nevertheless a very real one as may be observed from the settlement of over $2,000,000 made by the directors in the *Trico* case.[11] In additon there lurks the possibility of a stockholder's suit to compel the declaration of dividends where the directors are remiss in this respect.[12]

3. The Close Corporations

While all of the financial and economic considerations which enter into the formulation of dividend policy should be equally applicable to all business corporations, tax considerations will be found to be more prominent in the case of the closely held corporation. The shareholder may properly desire to continue unaltered the corporate ownership and control. He, also, has as much interest as the shareholder of the widely held corporation in realizing gains on increases in the value of his holdings at the lowest possible tax rate. If all of the stock of the corporation is common, the shareholder, upon the sale of any part of it, may pay only a capital gains tax but will have lost a portion of the control which he may desire to retain. Prior to the enactment of the 1954 Code, if there was preferred stock, he might have retained for himself or his successor the management and control of the corporation and, nevertheless, disposed, at capital gains rates, of equities for which a market might have been available.

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[7] See *Trico Products Corp.*, 46 B.T.A. 346 (1942), affirmed (2 Cir. 1943), 137 F. 2d 424, 31 AFTR 394, cert. den. 320 U.S. 799 (1943); *Trico Products Corp.* v. *McGowan* (D.C., W.D. N.Y. 1946), 67 F. Supp. 311, 35 AFTR 234, affirmed (2 Cir. 1948), 169 F. 2d 343, 37 AFTR 176, cert. den. 335 U.S. 899 (1948). See also 1939 IRC, § 102.

[8] See Robert S. Holzman, "Management's Personal Liability for Section 102 Surtaxes," *Proceedings of New York University Seventh Annual Institute on Federal Taxation*, page 555. New York: Matthew Bender and Company, 1949; Jay Slonim, "How to Cope With the Section 102 Bugaboo," *Proceedings of New York University Seventh Annual Institute on Federal Taxation*, page 533. New York: Matthew Bender and Company, 1949; Note, "Derivative Actions Arising from Payment of Penalty Taxes Under Section 102," *Columbia Law Review*, March 1949, Vol. 49, page 394.

[9] Note, "Derivative Actions Arising from Payment of Penalty Taxes Under Section 102," *Columbia Law Review*, March, 1949, Vol. 49, page 394.

[10] See, e.g., *Avery* v. *Commissioner* (5 Cir. 1927), 22 F. 2d 6, 6 AFTR 7019; Rule 32, Rules of Practice Before the Tax Court of the United States; Herman H. Copelon, "Practical Problems on Burden of Proof in Civil Trials," *Proceedings of New York University Tenth Annual Institute on Federal Taxation*, page 865. New York: Matthew Bender and Company, 1952.

[11] See New York Supreme Court, New York County File 28485-1947.

[12] *Dodge* v. *Ford Motor Co.*, 204 Mich. 459 (1919).

This result is what the Treasury devoutly sought to prevent. The fear of what was in effect a "bailout" of corporate earnings at capital gains rates led the Treasury Department to restrict, carefully, its rulings on the non-taxability of stock dividends.[13] Under the 1954 Code, this "bailout" appears to have been effectively curtailed, by making the sale or disposition of the preferred stock dividend taxable as ordinary income[14] rather than relying on the courts to hold the stock dividend to be income under the Sixteenth Amendment to the Constitution.

Freezing surplus. You might appropriately use a stock dividend to freeze surplus so that creditors will be assured of adequate working capital. But if your surplus is large, you should be able to demonstrate the necessity and reasonableness of its retention. It is clear that unless the stock dividend is taxable (which under the new law will be the exceptional case), it will not prevent the imposition of the surtax under Section 531.[15] Hence, if you are considering a stock dividend, you should not wait until the surplus becomes so large that the mere declaration of the dividend may lead to the surmise that your dividend is a cover-up for an unreasonable surplus rather than an assurance to creditors.

Incentive distribution. In recent years many corporations and their major stockholders have found it beneficial, and in some cases necessary, to permit officers and employees to acquire a direct financial interest in the corporation as stockholders in order that the corporation may "more effectually secure new employees and develop men of executive ability." [16] In this situation the stock dividend, and particularly the preferred stock dividend, can play a useful part.

Under certain circumstances, it was possible under the 1939 Code to obtain advance rulings and closing agreements relating to the nontaxable status of the preferred stock to be obtained by the shareholders as a dividend. With the enactment of the 1954 Code, however, you need no such ruling. You must bear in mind, however, that the realization on the sale or disposition of the stock received as a dividend, may be taxed as ordinary income.

Estate planning. Where it is necessary to plan for the payment of estate taxes or other obligations on the death of one of the shareholders, in a closely held corporation, further difficult problems are presented. It might be desired that control of the corporation be retained within a family or management group, but cash may be obtainable only by relinquishing a part of the common stock to outsiders, thus diluting control, or by acquiring some of the accumulated earnings from the corporation itself. If the estate is the holder of marketable preferred stock, it may be disposed of without the loss of control. On the other hand, the controlling stockholder, even during his lifetime, may find his interest best served by disposing of common stock to a management group and retaining preferred stock. In this way the investment in a satisfactory enterprise can be continued;

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[13] Norris Darrell, "Recent Developments in Nontaxable Reorganizations and Stock Dividends," *Harvard Law Review*, June, 1948, Vol. 61, page 958. See also, Special Ruling of Commissioner of Internal Revenue, Letter dated December 29, 1947, 1948 P-H Fed. Tax Service Paragraph 76,191.

[14] 1954 IRC § 306.

[15] 1954 IRC § 312(d).

[16] **See Special Ruling, footnote 13, above.**

proper management can be assured; and the cash and income requirements of the stockholder and his family can be satisfied.

In the case of estates, the otherwise unanticipated redemption of preferred stock, to pay administration expenses and taxes, may avoid a forced sale of valuable assets and make it possible to continue the control of a thriving business in the decedent's heirs. Until September of 1950 such a redemption might have encountered difficulty with Section 115(g) of the 1939 Code. To some extent this situation was ameliorated by the Revenue Acts of 1950 and 1951,[17] and now Section 303 of the 1954 Code affords greater leeway in this respect.[18]

The foregoing discussion will indicate that under the 1939 Code the declaration of a stock dividend by the publicly held corporation did not often raise a serious tax question. In the case of the close corporation or the widely held corporation with a management group holding a substantial amount of stock, however, tax considerations were given a great deal of attention. Under the 1954 Code, no different problem will concern the publicly held corporation. The emphasis has been changed, however, insofar as the close corporation is concerned. There the tax problem now presents itself upon the sale or disposition of the stock received as a stock dividend rather than upon the distribution of the dividend itself. In order to understand the provisions of the 1954 Code, however, it is important to review, briefly, the turbid history of the stock dividend under the prior law.

4. Case History

Prior to the enactment of the 1954 Code, the history of the taxation of stock dividends indicated a constant attempt on the part of the Treasury Department to tax the stock dividend when it was declared and received by a stockholder. The Treasury constantly contended that any change in the nature of a stockholder's interest occasioned by a distribution of a stock dividend resulted in income to the shareholder. It even went so far as to claim that a dividend of common stock on common stock should constitute taxable income.[19] It received only slight consolation in the cases which reached the courts during this time.

Although the Revenue Act of 1913 provided that net income should include "dividends" and also "gains or profits and income derived from any source whatever," [20] the Supreme Court held in *Towne* v. *Eisner*[21] that a stock dividend of common on common was not taxable.

The Revenue Act of 1916 provided that the term "dividend" means "any distribution made or ordered to be made by a corporation." [22] This Act was considered in *Eisner* v. *Macomber*.[23] There the Supreme Court held that the dividend was not taxable because it was not income within the meaning of the

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[17] Revenue Act of 1950, § 208; Revenue Act of 1951, § 320(a); 1939 IRC, §115(g)(3).

[18] 1954 IRC § 303(a), (b).

[19] See Government's brief in *Edwin L. Wiegand*, 14 T.C. 136 (1950).

[20] Revenue Act of 1913, § B, 38 Stat. 114, 167, c.16.

[21] 245 U.S. 418, 3 AFTR 2959 (1918).

[22] Revenue Act of 1916, § 2(a), 39 Stat. 756 et. seq., c.463.

[23] 252 U.S. 189, 3 AFTR 3020 (1920).

Sixteenth Amendment to the Consitution, but was merely a restatement of an existing interest in the corporation.

The Revenue Act of 1921 contained a provision broadly exempting stock dividends from tax.[24] This provision was continued without change until the Revenue Act of 1936.

In spite of this, in *Koshland* v. *Helvering*,[25] decided in 1936 under the 1921 Act, a dividend of common on preferred was held to be constitutionally taxable. The Supreme Court pointed out that "where a stock dividend gives the stockholder an interest different from that which his former stockholdings represented, he receives income." [26] In 1937 the Supreme Court in *Helvering* v. *Gowran*[27] declared that where both common and preferred stock were outstanding a dividend of preferred on common stock could be taxed by Congress.

The Revenue Act of 1936 enacted what was Section 115(f)(1) of the 1939 Code which exempted stock dividends from taxation except to the extent that they constituted income within the Sixteenth Amendment to the Constitution. The first case decided by the Supreme Court under this statute was *Helvering* v. *Griffiths*[28] involving a dividend of common on common. There the government attacked *Eisner* v. *Macomber* but the court held, Justices Black and Douglas dissenting, that it was not the intention of Congress to override that decision.

In the next two cases to reach the Supreme Court, *Helvering* v. *Sprouse* and *Strassburger* v. *Commissioner*,[29] decided in 1943, a dividend of non-voting common on both common and non-voting common (*Sprouse*), and a dividend of preferred on common, where only the common was outstanding (*Strassburger*), were held to be non-taxable. Here Justices Reed, Frankfurter and Jackson dissented. In those cases the majority opinion stated that to render "the dividend taxable as income there must be a change brought about by the issue of shares as a dividend whereby the proportional interest of the stockholder was essentially different from his former interest." [30]

In spite of its lack of success in the Supreme Court in its effort to establish that all stock dividends are taxable, the Treasury Department continued to press the issue.[31]

The *Wiegand* and *Tourtelot* cases grew out of the same dividend declaration.[32] The corporation had outstanding two classes of stock, common A voting with a first preference as to dividends and liquidation and common B non-voting with a second preference as to dividends and liquidation. After the preferences of these two classes were, respectively, satisfied, both classes would share proportionately in dividends and liquidation on the basis of 1 to 6. In April of 1940, the corporation declared a 50 per cent stock dividend of common A on common A and a similar dividend of common B on common B. The Commissioner determined that these dividends were taxable stock dividends. The majority of the Tax Court, with five judges dissenting, supported the Commissioner. The case was appealed to the Seventh Circuit under the name of *Tourtelot*[33] and to the Third Circuit under the name of *Wiegand*.[34]

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[24] Revenue Act of 1921, § 201(d), 42 Stat. 227, 228, c.136.

[25] 298 U.S. 441, 17 AFTR 1213 (1936).

[26] 298 U.S. 441, 446, 17 AFTR 1213, 1215.

[27] 302 U.S. 238, 19 AFTR 1226 (1937).

[28] 318 U.S. 371, 30 AFTR 403 (1943).

[29] 318 U.S. 604, 30 AFTR 1087 (1943) (decided together).

[30] 318 U.S. 604, 608, 30 AFTR 1087, 1089.

[31] *Estate of Joseph E. Sorg*, par. 43,164 Prentice-Hall Memorandum T.C. (1943); *Winton M. Blount*, par. 43,195 Prentice-Hall Memorandum T.C. (1943); *Wiegand* v. *Commissioner* (3 Cir. 1951), 1951 P-H Fed. Tax Service par. 72,484, on rehearing (3 Cir. 1952), 194 F. 2d 479, 41 AFTR 721; *Tourtelot* v. *Commissioner* (7 Cir. 1951), 189 F. 2d 167, 40 AFTR 668; *C. P. Chamberlin*, 18 T.C. 164 (1952); *John A. Messer, Sr.*, 20 T.C. 264, 1953; *Joseph P. Schmitt*, 20 T.C. 352 (1953), reversed (3 Cir. 1954) 208 F. 2d 819.

[32] *Edwin L. Wiegand*, 14 T.C. 136 (1950).

The *Tourtelot* stockholders had the same percentage of common A as they had of common B stock and hence, as the court there points out, although the rights of the common B holders may have been postponed in favor of the common A, since the same holder held common B stock in that case, the sum total of all his rights was exactly the same after as before the dividend.

In the Third Circuit, the court on the first hearing upheld the Tax Court,[35] but upon a rehearing reversed itself and held the dividend was not taxable.[36] The Court of Appeals, although it recognized that as a result of the stock dividend a common A stockholder might receive a little more money, when dividends are declared, before the common B stockholder could get anything, held that this did not constitute an alteration of the legal rights of the stockholders, or as they explained it in the footnote,[37] the "cuts or the proportional interests of the A and B stockholders remained the same after as before the dividend." As the court put it, the B stockholders would be "eating lower down on the hog, but that the hog had grown bigger."

Thus, it would appear that the *Wiegand* litigation effected no change in the doctrine set forth in *Eisner* v. *Macomber* and cases that followed, such as the *Sprouse*[38] and *Strassburger*[39] cases, namely, that a stock dividend which effects no change in the proportionate interest, that is, no difference in the ownership interest in the corporation of a particular stockholder, is not taxable.

The *C. P. Chamberlin* case decided in October, 1953,[40] is probably the best example of the preferred stock "bailout" which the 1954 Code seeks to eliminate. This case involved a dividend of preferred stock on common stock where only common stock was outstanding, which preferred stock was sold by the stockholders immediately following its distribution. The factors which made this appear to be an excellent case for the Government can be summarized as follows:

1. Prior to declaring the preferred stock dividend, the directors became concerned about a possible Section 102 tax[41] due to the corporation's substantial accumulated surplus.
2. The stockholders did not want to declare cash dividends because at least one of the substantial stockholders was in a high surtax bracket.
3. The purpose of the issue was to enable the owners to take money out of

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[33] Footnote 31, above.
[34] Footnote 31, above.
[35] *Wiegand* v. *Commissioner* (3 Cir. 1951), 1951 P-H Fed. Tax Service, par. 72,484.
[36] *Wiegand* v. *Commissioner* (3 Cir. 1952), 194 F. 2d 479, 41 AFTR 721.
[37] 194 F. 2d 479, 481, 41 AFTR 721, 723.
[38] Footnote 29, above.
[39] Footnote 29, above.
[40] (6 Cir. 1953) 207 F. 2d 462; 44 AFTR 494; cert. den. 347 U.S. 918.
[41] Now 1954 IRC § 531.

the company and to pay thereon a capital gains tax of 25 per cent rather than the normal personal income tax rates.

4. Also, and this is quite important, negotiations took place between the stockholders or officers of the company, the company itself and agents for an insurance company with a view towards effecting a sale to the insurance company of the preferred stock issue; plans to create and issue the preferred stock dividend were brought to fruition only after the insurance company certified its willingness to purchase the issue. In addition, the terms of sale of the preferred stock with its privileges and preferences afforded the purchaser "the degree of protection usually found in a first lien bond issue," such as a mandatory maturity date, a sinking fund, and the necessity of maintaining certain ratio of current assets to liabilities.[42]

In other words, we had in the *Chamberlin* case a pre-arranged plan for the sale of the preferred stock if and when the dividend should be declared and an issue by a corporation having un-needed surplus under agreements by which that surplus was practically earmarked for the redemption of the stock itself. It would be difficult to have imagined a better case for the Government, and in fact, the Government did prevail in the Tax Court.[43] The Tax Court held the attending circumstances and conditions made the distribution equivalent to a cash dividend, that the real purpose of the issuance of the preferred stock was to place the issue in the hands of non-stockholders, thereby substantially altering the common stockholder's pre-existing proportionate interests, and that the dividend was not issued for a bona fide business purpose. The Tax Court was reversed by the Circuit Court[44] on the ground that the case fell within *Towne* v. *Eisner* and *Eisner* v. *Macomber* and was controlled by *Strassburger*; that the dividend did not change the proportionate interests; that the time for determining whether or not a dividend is taxable by reason of a change of proportionate interests is the date when the dividend is received, and that business purpose is immaterial in considering the taxability of a stock dividend. The Circuit Court thus ignored what was considered a fairly well established principle of tax law for many years, namely, that a series of steps in a given transaction may not be isolated as separate transactions to permit escape from tax liability simply because each step in the transaction has legal validity.[45]

Hence, prior to the 1954 Code, it would seem that a change in proportionate interests was still the test of the taxability of stock dividends, the Courts having simply said that where the stock dividend has not changed the stockholder's interest, he did not realize anything and thus had no income to be taxed. As the Third Circuit said in the *Wiegand* case, the proportionate interest doctrine was based on the theory that when the taxpayer received a stock dividend, it did not alter his legal rights, and hence "he does not incur the incidence of 'income' taxation within the purview of the Sixteenth Amendment." It might be said that the *Chamberlin* case extended this doctrine to the situation where the stock dividend was accompanied by a mechanism whose purpose was to bail out the earnings and profits of the corporation.

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[42] *C. P. Chamberlin,* 18 T.C. 164, 170, 171; pages 18 and 19, Transcript of Record on Appeal of C. P. Chamberlin in the United States Court of Appeals for the Sixth Circuit.

[43] *C. P. Chamberlin,* 18 T.C. 164.

[44] *C. P. Chamberlin,* footnote 40, above.

[45] Paul & Zimet, "Step Transactions," in *Selected Studies in Federal Taxation, Second Series,* page 200. Chicago: Callaghan and Company, 1938.

Internal Revenue Code of 1954

The provisions affecting the distribution of stock dividends are found in Sections 305 and 306 of the 1954 Code. As has been indicated in the previous discussion, the general effect of these provisions is to exempt the stock dividend from taxation when it is distributed to the taxpayer, but to subject the stock dividend to taxation upon its sale or other disposition.

There are, of course, a number of exceptions to this general rule and it will be the purpose of the balance of this Chapter to outline the circumstances under which the tax will be imposed, as well as those under which the disposition may escape taxation, and to point up some of the problems which will now present themselves to plague the taxpayer in this realm of the tax law.

5. Taxable and Non-taxable Stock Dividends

Section 305(a) of the 1954 Code specifically states that "gross income does not include the amount of any distribution made by a corporation to its shareholders, with respect to the stock of such corporation, in its stock or in rights to acquire its stock."

Where, however, it is essentially the equivalent of money or other property, a stock dividend will be taxable at the time it is distributed and whether or not it is declared in common or preferred stock. This treatment obtains where the stock distribution is for the purpose of discharging preference dividends for the current taxable year or the preceding taxable year. This serves to exclude a stock dividend for the purpose of discharging preference dividends for a period prior to the preceding taxable year. A stock distribution will also be taxable if it is made upon such conditions that the shareholders have the option to receive cash or other property instead of stock.[46]

6. The Preferred Stock Bail-Out—"Section 306 Stock"

Although the Congress was content to permit the receipt of stock dividends by a stockholder without the imposition of tax liability, they were particularly concerned with the preferred stock bail-out as exemplified in the *Chamberlin* case.[47] Section 306 of the 1954 Code, therefore, contains rules whose purpose is to prevent such action. Principally this is accomplished by levying a tax on the sale or other disposition of what is defined in that section as "Section 306 stock," an appellation which probably will become as common in usage as "Section 102" of the 1939 Code.

Section 306(c) sets forth three categories of stock dividends which will be known as "Section 306 stock":

The first category[48] is stock distributed to the shareholder selling or otherwise disposing[49] of the stock where any part of the distribution did not constitute taxable income to the shareholder under Section 305(a). This category specifically excludes a dividend of common stock issued with respect to common stock. It should be noted, however, that a dividend of common stock issued in lieu of money is not "Section 306 stock" because it is taxable under Section 305. On the other hand, a dividend of common stock issued to discharge preference dividends appears to be "Section 306 stock" at least to the extent of the stock dividends allocable to the preference dividends for the period prior to the fiscal year preceding the year of distribution. It is not beyond the realm of probability, that under the language of the statute, the Commissioner may even argue that a single stock distribution of common stock in the discharge of preference dividends, applicable both to the current year, the preceding year and years prior thereto, is entirely "Section 306 stock" even though the amount allocable to the current year and the preceding taxable year is includible in the income of the recipient. It is believed, however, that no such result is intended by the statute.[49a]

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[46] 1954 IRC § 305(b).

[47] S. Rep. No. 1622, 83d Cong. 2d Sess. 46, 241 (1954). Hereafter, this Report will be cited as "Senate Finance Committee Report."

[48] 1954 IRC § 306(c)(1)(A); Proposed Regulations § 1.306-3(c).

The second category[50] includes stock which has a Section 306 taint because, in the hands of the seller it has a transferred or substituted basis. For example, "Section 306 stock" received as a gift will carry with it not only the basis but also the Section 306 taint. Furthermore, common or preferred stock received in a non-taxable exchange for "Section 306 stock" will become "Section 306 stock" while the stock transferred for it will remain "Section 306 stock." [51] If, however, a person owning Section 306 preferred stock exchanges it with another shareholder for common stock in the same corporation, this would be a taxable exchange;[52] the common stock received in this type of exchange would not be tainted by Section 306;[53] but the transfer of the "Section 306 stock" would be considered a disposition. "Section 306 stock" also loses its taint when it is includible in the gross estate of the decedent, since such stock takes on a new basis. This probably would not apply where the donee of a gift in contemplation of death has disposed of the stock prior to the death of the donor.[54]

The second category does not encompass stock received under certain of the reorganization sections of the 1954 Code, even though stock so received carries with it a substituted basis. Special treatment is given this stock which becomes the third category.

The third category[55] is stock other than common stock received by the redeeming or selling shareholder under certain of the reorganization sections of the 1954 Code[56] where gain or loss to the shareholder was not recognized upon the receipt of the stock and where either the transaction was substantially the same as the receipt of a stock dividend or the stock so received was received in exchange for "Section 306 stock." It is believed that examples of this type of situation would involve a recapitalization of the corporation having only common stock outstanding where after the recapitalization it had preferred and common outstanding, or a reorganization in which the holder of "Section 306 stock" surrenders it in exchange for stock other than common stock. In these instances, the stock received, other than common stock, would carry the taint of "Section 306 stock." It should be noted that, in this category, common stock received in exchange for "Section 306 stock" is not tainted.

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[49] The term "sale or disposition" and the term "selling or otherwise disposing" have been used to indicate any kind of disposition including redemption. In the interest of brevity, the terms "sale," "disposition," "selling," and "disposing" will be used interchangeably to indicate a disposition other than redemption, and when redemption is intended, the term "redemption" will be used.

[49a] The proposed regulations support this position. See §§ 1.305-1, 1.306-3(c).

[50] 1954 IRC § 306(c)(1)(C).; Proposed Regulations § 1.306-3(e).

[51] Senate Finance Committee Report, page 244; Proposed Regulations § 1.306-3(e).

[52] 1954 IRC § 1036(a).

[53] Footnote 50, above.

[54] Senate Finance Committee Report, pages 245, 423; 1954 IRC §§ 1014(a), 1014(b)(9); Proposed Regulations § 1.303-3(e).

[55] 1954 IRC § 306(c)(1)(B); Proposed Regulations § 1.306-3(d).

[56] 1954 IRC §§ 368(a), 355.

What is common stock? It will be observed that the definition of "Section 306 stock" has specifically excluded therefrom common stock when issued as a dividend on the common stock. This would be delightfully clear if Congress had gone a little further and told us exactly what they meant by "common stock." The failure to define it would seem to justify us in assuming that Congress intended as common stock what has been known as common stock down through the years under the tax laws. Should we make this assumption, it would appear that a non-voting common dividend on common stock is not "Section 306 stock."[57]

Non-voting common stock having preferences such as were found in the *Wiegand* case, however, presents a more difficult problem even though it is generally accepted as common stock.

It is conceivable that non-voting common stock dividends may be used for bail-out purposes. For example, if the stockholder of a corporation having a capital of $100,000 and a surplus of $100,000 should cause to be issued a stock dividend in non-voting common stock in the amount of its surplus under the circumstances that were present in the *Chamberlin* case, the definition of "Section 306 stock" would seem to allow the same results which were obtained in that case. The voting stockholders would have the same capital interest and the same control which they had prior to the distribution and disposition of the non-voting common stock dividend. Unless it is held that such a transaction involves the attribution of a conversion privilege to the stock dividend under Section 306(e)(2), there may still be room for a bail-out via the *Chamberlin* method.

7. Disposition of "Section 306 Stock"

With certain limitations, the amount which is realized on the disposition of "Section 306 stock" is taxable at ordinary income rates and the date of distribution of the stock dividend rather than the date of disposition governs.[58] Thus, as illustrated by the Senate Committee Report, if a stockholder owns 1,000 shares of the common stock of a corporation and they constitute all the outstanding shares, and if at a time when the corporation has $100,000 in accumulated earnings, a dividend is declared on the common stock of 1,000 shares of preferred stock ("Section 306 stock"), each share having a market value of $100, there is no tax on the receipt of the preferred stock, but if all of that stock is later sold for $100,000, the seller will be taxed on the entire $100,000 at ordinary income rates. This same treatment will apply even if between the time of receipt of the stock dividend and its later disposition, a dividend of $100,000 in cash were to be distributed leaving the corporation without earnings when the stockholder sells his "Section 306 stock."[59]

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[57] *Helvering* v. *Sprouse*, footnote 29, above. Common stock can, however, change its spots. See *infra*, "Miscellaneous—Convertible stock."

[58] 1954 IRC § 306(a)(1).

The entire amount realized upon the disposition of "Section 306 stock" will not be taxed necessarily as ordinary income. If it exceeds the ratable share of the corporate earnings allocable to the "Section 306 stock" at the date of its distribution, the excess will be treated as the amount realized on the sale of a capital asset; that is, as a return of capital to the extent of basis and the balance taxed as capital gain. No loss will be recognized.[60]

8. Redemption of "Section 306 Stock"

The redemption of "Section 306 stock" is effected in the same manner as the redemption of any other stock; that is, it involves the acquisition by the corporation of stock from a stockholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.[61] Where, however, the stock redeemed is "Section 306 stock" then the redemption may not be effected necessarily at capital gains rates; the dividend distribution sections of the 1954 Code determine the amount to be taxed in this type of redemption.[62] To the extent that the value of money and property distributed in redemption of "Section 306 stock" is equal to the accumulated earnings and profits as of the date of redemption, it is treated as a dividend. If the value of the assets so distributed in redemption is greater than the accumulated earnings and profits at that date, then the amount of such value to the extent of the basis of the "Section 306 stock" is treated as a return of capital; and if the value of such distribution exceeds not only the earnings and profits accumulated at the date of the redemption but also the basis of the "Section 306 stock" then the excess is taxed as a capital gain.[63]

It is important to note that tax liability in redemptions is determined as of the date of redemption of the "Section 306 stock" rather than the date of its distribution. Hence, redemption may afford advantages over disposition. If earnings and profits at the date of the distribution of the stock dividend were substantially lower than they are at the date of the proposed redemption or proposed disposition, then a disposition rather than a redemption would appear to be more advantageous. On the other hand, if at the time of the proposed disposition, the earnings and profits are less than they were at the date of the distribution of the stock dividend, then redemption would seem to be preferable to disposition. Of course, in considering the relative merits of these methods, the corporate stockholder should be aware of the added benefits from redemption through the medium of the dividends received credit.[64]

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[59] Senate Finance Committee Report, page 242.

[60] 1954 IRC §§ 306(a)(1)(B), 306(a)(1)(C); Proposed Regulations § 1.306-1(a).

[61] 1954 IRC §§ 306(a)(2), 317(b).

[62] 1954 IRC § 301; Senate Finance Committee Report, page 242. Cf. 1954 IRC § 302; Proposed Regulations § 1.306-1(c).

[63] 1954 IRC §§ 301(c), 316(a); See also 1954 IRC § 312, Senate Finance Committee Report, page 242, and Cf. 1939 IRC § 115(a), *Commissioner* v. *Fannie Hirshon Trust* (2nd Cir. 1954), 213 F. 2d 523, 45 AFTR 1608; *Commissioner* v. *Estate of Ida S. Godley* (3rd Cir. 1954), 213 F. 2d 529, 45 AFTR 1614.

9. Basis in Section 306 Transactions

The rule regarding determination of the basis of a stock dividend is the same under the 1954 Code as it was under the 1939 Code. Essentially, the distribution of a tax-free stock dividend requires an allocation of the basis of the original stock (commonly known as "old stock") between the stock dividend and the old stock. The method of allocation is to be determined by the Commissioner's regulations. The regulations in this respect, issued pursuant to the 1939 Code, provide that the allocation should be made between the two types of stock, based upon the respective market values of the two issues as of the date of the distribution.[65]

When the Commissioner's regulations under the 1954 Code are promulgated they should take into consideration, if possible, the new facets of the allocation problem which are presented by Section 306; otherwise, a shareholder who is taxed under Section 306 may suffer an inequitable detriment in the loss of that part of the basis of his original stock which is required to be allocated to the "Section 306 stock."

Let us take a case in which a common stockholder receives a preferred stock dividend to which one-half of the basis of the common stock must be allocated. Under the 1954 Code, the preferred stock becomes "Section 306 stock"; if the shareholder disposes of the preferred stock at a price equal[66] to the ratable amount of earnings and profits appropriately allocable to that stock, the Commissioner might contend that the shareholder has lost, forever, that part of the basis which was allocated to that stock. The basis of his common stock would be reduced by one-half despite the fact that the shareholder has been taxed on the disposition of his "Section 306 stock" as if he had received a taxable dividend from the corporation, without the benefit of the part of the original basis allocable to the preferred stock. The Commissioner has apparently contended for just this type of treatment where the counterpart of Section 115(g) of the 1939 Code was involved.[67]

It is submitted that the Commissioner is enabled by the statute itself to avoid such an inequity. The allocation need not be made once and for all at the time that the "Section 306 stock" is distributed as a dividend; determination of basis need only be made at a time when it becomes necessary to compute gain or loss on the sale or exchange of the old stock, or the amount of basis deductible in computing gain on the disposition of the "Section 306 stock." [68]

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[64] 1954 IRC §§ 306(a)(2), 301, 34, 243; Senate Finance Committee Report, page 242.

[65] 1954 IRC § 307; Reg. 118, §§ 39.113(a)(12)-1; 39.113(a)(19)-1; Proposed Regulations § 1.307-1(a).

[66] A similar inequity will exist if the amount realized is more than the ratable share of earnings and profits but less than such ratable share plus the basis ascribed to the distributed stock.

[67] *Randolph* v. *Commissioner* (8 Cir. 1935), 76 F. 2d 472, 15 AFTR 1152, cert. den. 296 U.S. 599; Richard Katcher, "The Case of the Forgotten Basis," *Michigan Law Review*, February, 1950, Vol. 48, page 465.

If, on the disposition of "Section 306 stock," the entire amount realized is taxable as ordinary income, then it is submitted that the entire basis should properly remain with the original stock. If there is realized an amount greater than the ratable portion of the earnings and profits as of the date of its distribution, then to the extent that the amount of the realization exceeds such earnings and profits, it will be considered a return of basis or capital gain if sufficient. To the extent that basis is thus returned, the old stock properly should be deprived of the basis that has been allocated to the "Section 306 stock." [69] If however, the original stock is disposed of before the "Section 306 stock," then appropriately the allocation should be made for determining the gain or loss on the disposition of the original stock. A disposition of the "Section 306 stock" following the disposition of the original stock probably will constitute a termination of the shareholder's interest and result in capital gain. In this case, the allocated basis would be used in computing capital gain.

It is submitted that the foregoing suggestions should apply, likewise, where a redemption of the "Section 306 stock" takes place, resulting in the distribution of a taxable dividend under Section 301 of the 1954 Code.[70]

10. Disposition of "Section 306 Stock" Not Ordinary Income

There are of course circumstances under which "Section 306 stock" may be redeemed or disposed of without resulting in ordinary income to the seller. In the first place, the statute specifically provides that where the taxpayer can establish that one of the principal purposes of the transaction is not income tax avoidance, the amount realized will not be taxed as ordinary income.[71] Of course, it should be observed that the taxpayer in such a case has the burden of establishing the lack of a tax avoidance scheme. The Senate Finance Committee Report would seem to indicate that the purpose of this omnibus provision is to avoid the impact of the new method of treating dispositions of stock dividends on minority stockholders, who are not in a position to control the actions of the corporation.[72] It is believed, however, that the scope of this provision is such that, regardless of whether or not the disposing stockholder holds a minority interest, if he can sustain the burden of establishing the absence of income tax avoidance, he should be able to escape the impact of the Section 306 method of treating stock dividends.

In addition to the foregoing, Section 306(b) sets forth other circumstances under which the disposing stockholder will not suffer the impact of Section 306 in connection with his disposition of "Section 306 stock."

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[68] 1954 IRC § 306(a)(1)(C) provides that no loss is recognized on the disposition or redemption of "Section 306 stock."

[69] 1954 IRC § 306(a)(1)B; Position supported by Proposed Regulations § 1.306-1(b).

[70] *Cf.* Katcher, *op. cit.* footnote 67, above.

[71] 1954 IRC § 306(b)(4).

[72] Senate Finance Committee Report, page 243.

Complete liquidation. The Code makes it clear that a complete liquidation of the corporation even where "Section 306 stock" is outstanding results in nothing other than capital gains treatment.[73]

Partial liquidation. The Congress has continued its long standing policy that a redemption of a part of a corporation's outstanding stock in connection with the contraction of the corporate business constitutes a partial liquidation. The surrender of stock in connection with a partial liquidation is still treated as a capital transaction even though the stock surrendered may be "Section 306 stock." [74]

Transactions involving non-recognition of gain or loss. Where the holder of "Section 306 stock" disposes of it in exchange for stock in a non-taxable transaction, such a disposition will not suffer the impact of Section 306. The stock received in exchange for the "Section 306 stock," however, will usually take on the taint of Section 306 unless it is common stock received in a reorganization. If, however, in connection with the exchange, money or property is received, it will be considered to have been an amount realized upon the disposition of "Section 306 stock." [75]

Termination by disposition. If a shareholder disposes of stock which is tainted by Section 306 to persons whose ownership would not be attributable to him, and, if upon such disposition, neither he nor any person whose ownership could be attributable to him retains any stock interest in the corporation, disposition is not taxable under Section 306.[76] No change in the treatment of this disposition is required merely by reason of the fact that the disposing shareholder maintains his connection with the corporation as an officer, director or employee.[77]

Termination by redemption. Where the termination is made by a redemption of the "Section 306 stock" by the corporation, the shareholder surrendering all of his stock will be able to treat the redemption as the sale or exchange of a capital asset.[78] The shareholder must be careful, however, about the application of the attribution rules. If the ownership of no person's stock can be attributed to him, then he will have nothing to be concerned about. If, however, any stock can be attributed to him, then the redemption will be taxed under Section 306.[79] But if immediately after the redemption, the shareholder severs his connection with the corporation, except as a creditor, and does not re-establish it for a period of ten years, the ownership of stock by members of his family will not be attributable to him.[80]

Elaborate and complicated rules are provided for reinstating the family attribution rules under certain circumstances unless the taxpayer can establish that the proscribed conditions were not brought about with the avoidance of federal income tax as one of the principal purposes.[81]

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[73] 1954 IRC § 306(b)(2).

[74] See footnote 73, above; 1954 IRC §§ 331, 346.

[75] 1954 IRC §§ 306(b)(3); IRC 1954, Conference Report, page 35.

[76] 1954 IRC § 306(b)(1)(A).

[77] 1954 IRC, Conference Report, page 35.

[78] 1954 IRC §§ 306(b)(1)(B), 302(a), 302(b)(3).

[79] 1954 IRC § 302(c)(1).

[80] 1954 IRC § 302(c)(2)(A).

[81] 1954 IRC § 302(c)(2)(B).

11. Miscellaneous

Stock rights. Section 306 also deals with stock rights which are issued as a dividend on the underlying stock. It provides that stock rights shall be treated as stock and that the stock acquired through the exercise of those rights shall be considered as having been distributed at the time that the rights are distributed to the extent of the fair market value of the rights at the time of distribution.[82]

Convertible stock. If stock issued as "Section 306 stock" is later exchanged for common stock of the same corporation pursuant to a conversion privilege, whether or not contained in the stock itself, the common stock so received is not to be treated as "Section 306 stock." This probably flows from the fact that this type of an exchange merely allows the stockholder, through the exercise of the conversion privilege, to place himself in the same position he would have enjoyed had he originally received a common stock dividend. Where, however, common stock issued as a stock dividend contains a conversion privilege so that it might be converted into property or stock other than common stock, the dividend will not be considered common stock but will be considered "Section 306 stock." [83]

Changes in stock conditions. We have seen that upon the disposition of "Section 306 stock," its ratable share of the earnings and profits at the date of distribution is treated as ordinary income. The statute also provides that the Section 306 taint does not obtain, if no part of the distribution would be a dividend if money were distributed in lieu of stock. Such a situation would exist if there were no earnings and profits at the date of distribution.[84]

If the ratable share of earnings and profits were finally to be determined as of the distribution date in all instances, the section could be circumvented by the simple expedient of increasing, after its distribution, the amount of earnings and profits allocable to the stock dividend. The Congress has provided, therefore, that if substantial changes are made in the terms and conditions of stock, its fair market value and its ratable share of earnings and profits shall be determined at the date of such change or at the date of distribution, at whichever they are greater.[85] Furthermore, where there are no earnings and profits at the date of distribution, but at the date of change such earnings and profits do exist, the stock distribution will nevertheless be saddled with the Section 306 taint.[86]

Prior law. It should be understood that the discussion in this Chapter regarding the provisions of the 1954 Code as it affects stock dividends and their disposition or redemption, does not apply to dividends which may have been distributed under prior Internal Revenue laws although disposed of or redeemed on or after June 22, 1954. The tax treatment accorded to such stock dividends will be determined pursuant to the 1939 Code as modified by the provisions of the 1954 Code other than Section 306.[87]

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[82] 1954 IRC § 306(d); for the basis of "stock rights," see 1954 IRC § 307(b).

[83] 1954 IRC § 306(e), Senate Finance Committee Report, page 245.

[84] 1954 IRC § 306(c)(2).

[85] 1954 IRC § 306(g)(1), (2).

[86] 1954 IRC § 306(g)(3).

[87] 1954 IRC § 306(h).

12. Conclusions

Now that we have considered the 1954 Code as it affects the distribution and redemption or disposition of stock dividends in most of its aspects, we may wish to consider how the new Code will affect some of the uses or purposes of stock dividends as outlined at the beginning of this Chapter.

Clearly, it will make no difference to the widely held corporation since the statute is so constructed that the recipients of stock dividends in widely held corporations, where the recipient is a minority stockholder and unable to have control, will not be affected by Section 306.

In the close corporation, the new law will not seriously restrict the distribution of stock dividends for the purposes previously considered. Assurance may still be given to creditors that the corporation will have ample working capital by the transfer of surplus to the capital account and the issuance of a stock dividend, even a preferred stock dividend. Upon formation of the corporation, consideration should be given to the issuance of a substantial amount of preferred stock which would, of course, not be "Section 306 stock";[88] this would allow for the issuance of common stock dividends when stock dividends are found desirable.

The dividend stock may still be used for incentive purposes if it does not involve a transfer for a consideration. An employee receiving part of a stockholder's dividend stock, however, will want to consider carefully the terms and conditions of his employment as they affect any such dividend stock. It is believed, however, that if upon termination of employment it is possible to establish that the distribution, the redemption and the disposition were not a part of a plan, one of whose principal purposes was the avoidance of income tax, then a redemption or disposition of the dividend stock upon the termination of the employment should not give the employee too much difficulty.

Most of the benefits derived from the use of the stock dividend for estate planning purposes are still available depending upon the exact details of the particular program. The new law affords a substantial advantage in connection with the determination of the basis of gifts of stock which may have been made in contemplation of death or to take effect in possession or enjoyment at or after death.

Tax considerations will still be an important consideration of the directors of close corporations. One very important change, however, is brought about by the 1954 Code; there will normally be no serious tax consequence on the mere distribution of the stock dividend since the taxable event is normally the redemption or disposition of the stock. If at the time of the distribution, the redemption or disposition is a subject of serious consideration, then there is a fair chance that income tax avoidance is one of the principal purposes of the whole plan; in that case it must be assumed that on redemption or disposition of the dividend stock, Section 306 will apply and ordinary income be realized.

The new law should be substantially effective in reducing the possibilities of executing a plan such as was found in the *Chamberlin* case.[89] Where the *Chamberlin* arrangement would involve preferred stock there would seem to be no question that the disposition would be ordinary income and taxable as such; *quaere*, as to whether or not the new law would be effective in a *Chamberlin* arrangement in which non-voting common stock is used?

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[88] Senate Finance Committee Report, page 245.

[89] See footnote 47, above.

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Stockholder Loans*

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Stockholders who also become creditors of the corporation in which they hold stock invariably create a host of difficult and complicated tax problems, both for their corporations and for themselves. And yet, it is often advantageous, taxwise, to create the creditor relationship between stockholder and corporation. Its creation, and subsequent transactions between creditor-stockholder and debtor-corporation, should be based upon as complete an understanding as possible of the tax problems involved and the methods of handling them.

This chapter assumes that the "loans" and "advances" made by a stockholder to his corporation give rise to bona fide debts, even for tax purposes, and that the inevitable preliminary question of whether they are to be treated simply as equity capital has been surmounted.

This chapter also is based upon application of the provisions of the Internal Revenue Code of 1954, with only occasional references to predecessor provisions of the 1939 Code. Cross references from the provisions of the 1954 Code to equivalent provisions of the 1939 Code can be found in the official print of the 1954 Code. However, the statutory provisions have not been substantially changed in this area, so that cases arising under the 1939 Code are generally still enlightening and relevant in interpreting provisions of the 1954 Code; these cases are cited in this chapter where appropriate. To the extent that changes have been made, problems in this field have been eliminated or minimized.

1. Points to Consider

The tax problems of the corporation-debtor include the following:

	Section
Under what conditions is the interest deductible?	2, 3
Will payment of the principal result in gain or loss?	4
What is the effect of a gratuitous cancellation of the debt?	5
May the accumulated earnings tax be imposed?	6

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The tax problems of the stockholder-creditor include the following:

	Section
Is a bad debt deduction available for a worthless loan?	7
What is the effect of a gratuitous cancellation of the debt? ...	8

2. Interest Deduction—General Rule

Section 163(a) of the 1954 Code provides for the deduction of "all interest paid or accrued within the taxable year on indebtedness." The courts have recognized that where a genuine debtor-creditor relationship exists between a corporation and its stockholders, the corporation is entitled to deduct interest as it would in respect of indebtedness of any other creditor.[1] If a bona fide creditor-debtor relationship is established, interest may be deducted even though the indebtedness is proportionate to stockholdings, although the facts will be more closely scrutinized in such a case.[2] And a deduction for interest on indebtedness held by a sole stockholder, such as indebtedness owed by a subsidiary to a parent corporation, has been allowed [3] although there is an indication in an earlier Second Circuit case that a contrary result might be reached.[4] Unlike indebtedness held by non-stockholders, the deductibility of interest on indebtedness to stockholders is limited by the provisions of Section 267.

3. Interest Deduction—Section 267

Section 267(a)(2) of the 1954 Code prohibits the deduction of interest owed by a corporation to an individual if four conditions co-exist: (1) the interest is not paid within 2½ months after the close of the taxable year, and (2) the interest is not includible in the gross income of the individual within that period, and (3) by reason of the method of accounting of the individual the amount of the interest is not, unless paid, includible in his gross income for his taxable year in which or with which the taxable year of the corporation ends, and (4) at the close of the corporation's taxable year or at any time within 2½ months thereafter more than 50 per cent in value of the corporation's outstanding stock is owned "directly or indirectly," as defined in Section 267(c), by or for the individual.[5] Interestingly enough, the predecessor of this section (Section 24(c) of the 1939 Code) has been held not to apply where a stockholder owns exactly 50 per cent of the stock and no more.[6]

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[1] *Authentic Realty Co., Inc.*, par. 40,404 Prentice-Hall Memorandum B.T.A. (1940); *Commissioner* v. *Miller Mill Co.* (5 Cir. 1939), 102 F. 2d 599, 22 AFTR 925. See, also, *Southport Mill, Ltd.* v. *Commissioner* (5 Cir. 1928), 26 F. 2d 17, 6 AFTR 7633 (5 Cir. 1930), 38 F. 2d 986, 8 AFTR 10463; *Boal's Rolls Corp.*, 16 B.T.A. 799 (1929).

[2] *Wilshire & Western Sandwiches, Inc.* v. *Commissioner* (9 Cir. 1949), 175 F. 2d 718, 38 AFTR 116.

[3] *Pittsburgh, Allegheny & McKees Rocks R. Co.*, par. 47,207 Prentice-Hall Memorandum T.C. (1947). See also *John W. Walter, Inc.*, 23 T.C. 550 (1954) (individual stockholder).

[4] *Prudence Securities Corp.* v. *Commissioner* (2 Cir. 1943), 135 F. 2d 340, 341, 30 AFTR 1446, 1447. See also *Kraft Foods Co.*, 21 T.C. 513 (1954) (on appeal to 2 Cir.).

[5] An interest deduction might also be disallowed where the relationship of the creditor and the corporation-debtor is that specified in Section 267(b)(3) and 267(b)(8).

[6] *Hewitt Rubber Co. of Pittsburgh*, par. 47,317 Prentice-Hall Memorandum T.C. (1947); *Halbrett Realty Corp.*, 15 T.C. 157 (1950).

Payment. If the corporation has actually "paid" the amount within its taxable year, or within 2½ months thereafter, the limitation will not be applicable. Payment in negotiable promissory notes, either demand or time notes, will permit the deduction, to the extent of their fair market value, provided the notes are given and taken as actual payment of the interest amount.[7]

Constructive receipt. If the interest is constructively received by the stockholder in his taxable year in which or with which the corporation's taxable year ended, it must be included in his income for that year, and hence the section is inapplicable. It is now also enough to avoid the section that interest has been constructively received by the stockholder within 2½ months after the corporation's taxable year ended. The usual tests of constructive receipt which are applicable where the issue is the taxability of the item as income to the individual, are undoubtedly applicable in a Section 167 question.[8] The interest must have been unconditionally credited to the stockholder's account on the corporation's books and made fully available to him to take it. However, it is not necessary that the corporation have enough cash on hand if it could have borrowed the money.[9] Obviously interest accruing in the taxable year but not becoming payable until a subsequent year cannot be deemed constructively received in the year of accrual.[10]

Different taxable years. Where the corporation is on a fiscal year basis and the individual is on a calendar year basis, it can be argued that payment more than 2½ months after the corporation's taxable year will not cause disallowance if the payment is made in the individual's calendar year. However, the statute might be interpreted to disallow the interest in such a case, so that payment should be made, in cash or negotiable notes, within 2½ months of the close of the corporation's taxable year or else the individual's separate account should be unconditionally credited on the corporate books with the amount of interest within that period.

To avoid a pitfall, where the corporation is indebted to the individual on several items, the corporation should designate the amount of interest as the particular item paid. Otherwise, state law might require application of the payment to some other item of indebtedness.[11]

Finally, it should be noted that if the deduction is disallowed under Section 167, it is forever lost to the corporation.

4. Gain or Loss on Payment of Debt

Payment of a debt in full with cash does not give rise to gain or loss problems for the debtor. When a debt is repaid with property, however, the basis of the property to the debtor must be matched against the amount of the debt thus repaid. If the basis is less than the amount repaid, then the debtor realizes a gain, but if the basis is more than the amount repaid, then the debtor realizes a loss. Whether the gain or loss is a capital gain or loss depends upon whether the property exchanged by the debtor is a capital asset.[12] These, and other, general principles are equally applicable when the creditor is a stockholder. The general rules with respect to disallowance of losses and with respect to tax benefits, both considered subsequently, should be kept in mind.

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[7] *Musselman Hub-Brake Co.* v. *Commissioner* (6 Cir. 1943), 139 F. 2d 65, 31 AFTR 1001; *Anthony P. Miller, Inc.* v. *Commissioner* (3 Cir. 1947), 164 F. 2d 268, 36 AFTR 250; *Commissioner* v. *Mundet Cork Corp.* (2 Cir. 1949), 173 F. 2d 757, 37 AFTR 1214, affirming per curiam, par. 48,119 Prentice-Hall Memorandum T.C. (1948); *Heatbath Corp.*, 14 T.C. 332 (1950). Rev. Rul. 55-608, 1955 I.R.B. No. 40 (p. 13).

[8] For examples of constructive receipt under the 1939 Code, see Reg. 118, § 39.42-3.

[9] *Ohio Battery & Ignition Co.*, 5 T.C. 283 (1945).

[10] *P. G. Lake, Inc.* v. *Commissioner* (5 Cir. 1945), 148 F. 2d 898, 33 AFTR 1200.

[11] *Lincoln Storage Warehouses* v. *Commissioner* (3 Cir. 1950), 189 F. 2d 337, 40 AFTR 691; *Swartz Land Corp.* v. *Commissioner* (5 Cir. 1952), 198 F. 2d 558, 42 AFTR 525. Cf. *The Barnebey-Cheney Engineering Co.*, par. 54,210 Prentice-Hall Memorandum T.C. (1954).

Distributions in liquidation. Distributions in liquidation by a corporate debtor to its stockholder-creditors most frequently give rise to these problems. The distribution must first be applied to the indebtedness, and only the balance will be considered a distribution in cancellation of stock or a "distribution in liquidation." [13] Distribution of property which is applied to the debt upon the liquidation will result in realization of gain or loss, unless the corporate debtor is insolvent before and after satisfaction of the indebtedness.[14]

Where the creditor is a corporation owning at least 80 per cent of the stock of the debtor-corporation, this problem has been eliminated by the 1954 Code. Previously, the Revenue Service had ruled in I.T. 4109, 1952-2 C.B. 138, that a subsidiary-debtor realized gain or loss upon a transfer to its parent of property at least equal in amount to the debt, with only the balance of the transferred property being subject to the provisions of Section 112(b)(6) of the 1939 Code. This ruling, and the *Northern Coal & Dock Co.* case,[15] upon which the ruling was based, have been changed prospectively by Section 332(c) of the 1954 Code. That provision states that if there is a complete liquidation of a subsidiary under Section 332, no gain or loss shall be recognized to the debtor-subsidiary corporation "because of the transfer of property in satisfaction of such indebtedness." The general rule has thus been abrogated in this special situation, although it remains relevant in all other situations.

Allocation of assets. If a bundle of assets, with a value in excess of the debt, is distributed in liquidation, a perplexing allocation problem arises. Which assets are applicable to the debt? Perhaps the current assets should be deemed to be first applicable. Or perhaps part of the value of each asset should be applied to the debt, in the ratio that the debt bears to the total value of the assets; in this case, gain might be realized on one asset and loss on another, and each asset would have to be classified to determine whether the gain or loss is ordinary or capital. The Internal Revenue Service has not offered any solution to this problem. I.T. 4109 did not touch upon it. Taxpayers should anticipate this problem by making their own reasonable allocations or, preferably, by paying off the debts prior to the liquidation.

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[12] *Peninsula Properties Co., Ltd.*, 47 B.T.A. 84 (1942); *O'Dell & Sons Co., Inc.* v. *Commissioner* (3 Cir. 1948), 169 F. 2d 247, 37 AFTR 173, affirming 8 T.C. 1165 (1947); *Lutz & Schramm Co.*, 1 T.C. 682 (1943).

[13] *Houston Natural Gas Corp.* v. *Commissioner* (5 Cir. 1949), 173 F. 2d 461, 37 AFTR 1137; *Northern Coal & Dock Co.*, 12 T.C. 42 (1949).

[14] *Dallas Transfer & Terminal Warehouse Co.* v. *Commissioner* (5 Cir. 1934), 70 F. 2d 95, 13 AFTR 930; *Main Properties, Inc.* 4 T.C. 364 (1944). However, in one case where the debtor satisfied the indebtedness in full with property having a lesser value and a lesser basis, it was indicated that the debtor apparently might still realize taxable gain despite insolvency. Cf. *Richard B. Gump*, par. 41,034 Prentice-Hall Memorandum B.T.A. (1941).

[15] Footnote 13, above.

Steps to be taken. Where potential gain is involved, steps should be taken to avoid its realization. Various methods can be employed. The most direct, and possibly the most satisfactory, where available, is to have the corporation offer and the stockholder accept in satisfaction of the debt high-basis assets., i.e., assets which are not worth more than their basis. Since the debt could be paid in cash, and probably even in cash derived from the sale of such assets, it does not seem that the satisfaction of the debt by transfer of those assets could reasonably be challenged as arbitrary.

If that procedure is unavailable, then probably the debt could be gratuitously cancelled by the stockholders as a contribution to the corporate debtor's capital, at least if the debt is held by all stockholders in proportion to their stockholdings. Such a gratuitous cancellation would not give rise to income to the corporate debtor, unless possibly it should be found as a fact that the debt was not gratuitously cancelled but was really cancelled in consideration of the transfer of assets.

5. Effect of Gratuitous Cancellation on the Debtor

The principles in this area have not been affected by the 1954 Code. Although H.R. 8300, as passed by the House of Representatives, contained a statutory formulation of rules as to when a debtor realized income from a cancellation of indebtedness, this provision was struck out by the Senate and does not appear in the 1954 Code. This results in leaving "the situation as it now exists, with the determination as to whether cancellation results in income to the debtor, and to what extent, to be settled according to rules developed by the courts." [16]

"In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt." [17] There may be some difficulty in determining what constitutes "gratuitous forgiveness," particularly if the creditor is not a sole stockholder. In situations not involving stockholders, the Supreme Court has tightened up the liberal implication of its decision in *Helvering* v. *American Dental Co.*,[18] by stating in its later *Jacobson* decision[19] that realization of income by a debtor upon cancellation of a debt turns upon "whether the transaction is in fact a transfer of something for the best price available or is a transfer or release of only a part of a claim for cash and the balance 'for nothing'."

In spite of the fact that subsequent lower court decisions have been disinclined to find that debt cancellation constituted a gift,[20] it does not yet appear that the general principles applicable to cancellation of debts held by stockholder-creditors are significantly changed by the *Jacobson* decision. Debt cancellations in that situation have not generally been found to give rise to income to the debtor.[21]

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[16] S. Rep. No. 1622, 83rd Cong., 2d Sess., page 13.

[17] Reg. 118, § 39.22(a)-13.

[18] 318 U.S. 322, 30 AFTR 397 (1943).

[19] *Commissioner* v. *Jacobson,* 336 U.S. 28, 37 AFTR 516 (1949).

[20] See *Astoria Marine Construction Co.,* 12 T.C. 798 (1949); *Spear Box Co., Inc.,* 13 T.C. 238 (1949), affirmed (2 Cir. 1950) 182 F. 2d 844, 39 AFTR 579; *The Marshall Drug Co.* v. *United States* (Ct. Cls. 1951), 95 F. Supp. 820, 40 AFTR 380, cert. den. 341 U.S. 948; *Standard Brass & Mfg. Co.,* 20 T.C. 371 (1953).

[21] *Commissioner* v. *Auto Strop Safety Razor Co.* (2 Cir. 1934), 74 F. 2d 226, 14 AFTR 828; *Carroll-McCreary Co., Inc.* v. *Commissioner* (2 Cir. 1941), 124 F. 2d 303, 28 AFTR 645; *George Hall Corp.,* 2 T.C. 146 (1943).

However, the Court of Appeals for the Eighth Circuit has held, in *Helvering* v. *Jane Holding Corp.*,[22] that taxable income did result to a debtor-corporation where it had benefitted taxwise from deductions in prior years and the creditor, the corporation's sole stockholder, derived a benefit other than merely an increase in the value of his equity. Furthermore, the Tax Court had indicated that a debtor-corporation may realize income if a stockholder merely allows the right to repayment of the debt to become barred by the statute of limitations rather than forgiving the debt voluntarily.[23]

Since a stockholder-creditor will ordinarily consider cancellation of his corporation's debt primarily from the standpoint of his stock interest, the transaction usually can be carried out in a manner least likely to create income. Where the debt is wholly forgiven, it should be done so expressly and as a contribution to the corporation's capital. If the debt is partially paid off and only partially forgiven in order to benefit the corporation, that intent, too, should be clearly spelled out to come within the Supreme Court's distinction in the *Jacobson* opinion.

There has been some controversy about whether forgiveness by a stockholder of such portions of a debt as had been previously deducted with tax benefit by the debtor, such as interest, will give rise to income to the debtor. The Treasury Regulations,[24] based upon the *Jane Holding Company* case,[25] adopt the view that income results. But the opposite result may well be reached by some courts.[26]

Consolidated returns. Special consideration must be given to a forgiveness transaction where the creditor and debtor are affiliated corporations filing consolidated returns under Section 1501 of the 1954 Code (Section 141 of the 1939 Code). The Treasury Regulations provide that if bonds issued by one member of an affiliated group are acquired by it from another member of the group during a consolidated return period in a transaction other than a distribution in liquidation in which gain or loss is recognized, the basis of the bonds to the transferror shall be deemed the purchase price for the purpose of determining gain or loss to the issuing company.[27] Presumably, the provision would also apply to other types of obligations besides bonds. Thus, during a consolidated return period, surrender to a subsidiary of its bonds purchased by the parent at less than the face amount will result in income to the subsidiary to the extent of the difference between the face amount of the bonds and the price paid for them by the parent. The benefits of Section 108 of the 1954 Code (Section 22(b)(9) of the 1939 Code) should be available, provided the necessary consent to an adjustment of basis of assets under Section 1017 of the 1954 Code (Section 113(b)(3) of the 1939 Code) is filed.

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[22] (8 Cir. 1940) 109 F. 2d 993, 24 AFTR 426.

[23] *Annis Van Nuys Schweppe*, 8 T.C. 1224 (1947), affirmed (9 Cir. 1948) 168 F. 2d 284, 36 AFTR 1037.

[24] Footnote 17, above.

[25] Footnote 22, above.

[26] *Carroll-McCreary Co.* v. *Commissioner*, footnote 21, above; *Chenango Textile Corp.* v. *Commissioner* (2 Cir. 1945), 148 F. 2d 296, 33 AFTR 931; *George Hall Corp.*, footnote 21, above; *Pancoast Hotel Co.*, 2 T.C. 362 (1943). See also *Helvering* v. *American Dental Co.*, footnote 18, above.

[27] Reg. § 1.1502-41. See also *American Packing & Provision Co.*, 36 B.T.A. 340 (1937).

6. Application of the Accumulated Earnings Tax

Ordinarily, use or accumulation of corporate profits to pay off corporate indebtedness will not invoke the accumulated earnings tax of Section 531 of the 1954 Code (Section 102 of the 1939 Code). The Treasury Regulations in fact state that profits are reasonably accumulated "if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation." [28] Where the loan was made in the ordinary course of business, for business reasons, it should make no difference that the lenders are also stockholders.[29]

If the "debt" is found to be in reality stock, repayment may well risk the imposition of the accumulated earnings tax. This is particularly apt to be so in cases of "thin incorporation." Where the so-called "debt" is set up upon incorporation, it might be found that the corporation was "formed" for the purpose of avoiding income tax on shareholders.[30] In that case, unreasonable accumulation of profits would be immaterial.

While one can only speculate about the application of the accumulated earnings tax, it should not be an obstacle where the loans from stockholders are bona fide and incurred for sound business reasons.

7. Bad Debt Deduction for Stockholder-Creditor

Although the most frequent question arising when a stockholder-creditor seeks to take a bad debt deduction for a loan to his corporation is whether there was really a loan or was a capital investment, this question will not be considered here, where it is assumed that the debt was a loan. It will also be assumed that the debt is worthless in whole or in part.

Section 166(a)(1) lays down the general rule that bad debts may be deducted in the year they become worthless.[31] However, this rule is subject to several important exceptions which frequently are applicable to stockholder-creditors.

Non-business bad debts. The most important exception is found in Section 166(d), providing for "non-business" bad debts; the loss from such bad debts is deductible only as a short-term capital loss and only in the year the debts become

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[28] Reg. 118, § 39.102-3. Section 537 of the 1954 Code provides that "reasonable needs of the business" includes reasonably anticipated needs; this would include the accumulation of funds to pay off debt.

[29] But see *Beim Co.* v. *Landy* (8 Cir. 1940), 113 F. 2d 897, 25 AFTR 554; *Mead Corp.*, 38 B.T.A. 687 (1938), reversed on other grounds (3 Cir. 1940), 116 F. 2d 187, 26 AFTR 1. In these cases, Section 102 of the 1939 Code was applied to corporations accumulating earnings to pay off obligations originally incurred by stockholders and assumed by the corporations.

[30] Apparently no case has ever held that the tax applied solely because the corporation was "formed" for the forbidden purpose. Prentice-Hall 1955 Federal Tax Service, Vol. I, par. 4721(9).

[31] If a debt is only partially worthless, under Section 166(a)(2) an amount no greater than the amount actually charged off by the taxpayer as worthless may be deducted provided the Commissioner is satisfied as to its partial worthlessness. For taxpayers using the bad debt reserve method, a reasonable addition to the reserve may be deducted in the discretion of the Commissioner in accordance with Section 166(c). On this general subject, see the chapter by Helmut O. Werner.

wholly worthless. However, this exception is not applicable to corporations since the losses on their debts are treated, in effect, as business losses in all cases. The statute defines a "non-business debt" to be one other than a debt created or acquired in connection with the taxpayer's trade or business[32] *or* a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. The bad debt provisions of Section 166 do not govern the deduction of worthless securities which is covered by Section 165(g).[33]

Classification. When an individual stockholder loans money to his corporation and the loan turns sour, the bad debt will generally be classified as a "non-business" bad debt unless the individual can show that his business is that of organizing and promoting various enterprises, of which the debtor-corporation is one.[34] This general statement, of course, is too generalized, for there are some circumstances under which some courts will allow the deduction without such a showing and some, notably the Second Circuit, which will disallow the deduction unless the individual is in the business of regularly lending money to enterprises. To elaborate: if an individual stockholder simply advances money to his corporation and if he is not otherwise engaged in the lending business, the loan, when it becomes worthless, will necessarily be a non-business bad debt.[35] Thus, a loan of money by an individual to a corporation for the purpose of protecting his investment will only give rise to a non-business bad debt when it becomes worthless, even though the individual actively engages in the management of the corporation's business.[36] The Tax Court and some other courts have allowed a deduction for a business bad debt when the individual can show he is a promoter engaged in financing and managing various enterprises.[37] But the Second Circuit, in the *Smith* case,[38] has laid down a much more stringent rule than heretofore imposed by other courts, namely that the individual must be found to be "regularly engaged in lending money to business enterprises"; although the taxpayer "was interested as an investor, manager, and creditor in a number of business enterprises," the combination of these activities was held not to change the result which would be reached if they were separately considered.

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[32] This clause was added by the 1954 Code and permits bad debts now to be classified as business bad debts if either created or acquired in connection with the taxpayer's trade or business regardless of the circumstances at the time they become worthless. S. Rep. No. 1622, 83d Cong. 2d Sess., p. 199.

[33] See Section 166(e).

[34] *Maloney* v. *Spencer* (9 Cir. 1949), 172 F. 2d 638, 37 AFTR 907, affirming (D.C., Ore., 1947) 73 F. Supp. 657, 36 AFTR 267; *Commissioner* v. *Stokes Estate* (3 Cir. 1953), 200 F. 2d 637, 42 AFTR 1011; *Vincent C. Campbell,* 11 T.C. 510 (1948); *Valentine E. Macy, Jr.,* par. 49,009 Prentice-Hall Memorandum T.C. (1949); *J. Noel Macy,* par. 49,197 Prentice-Hall Memorandum T.C. (1949); *Henry E. Sage,* 15 T.C. 299 (1950); *A. Kingsley Ferguson,* 16 T.C. 1248 (1951); *Jan. G. J. Boissevain,* 17 T.C. 325 (1951); *William P. Palmer Estate,* 17 T.C. 702 (1951).

[35] *James M. Straub,* 13 T.C. 288 (1949).

[36] *L. F. Crofoot,* par. 49,236 Prentice-Hall Memorandum T.C. (1949), affirmed sub. nom. *Omaha National Bank* v. *Commissioner* (8 Cir. 1950), 183 F. 2d 899, 39 AFTR 818. See also *Arthur V. McDermott,* 13 T.C. 468 (1949); *Van Pelt* v. *Commissioner* (6 Cir. 1951), 191 F. 2d 861, 41 AFTR 167, affirming par. 50,193 Prentice-Hall Memorandum T.C. (1950); *Sogg* v. *Commissioner* (6 Cir. 1952), 194 F. 2d 540, 41 AFTR 848, affirming par. 50,251 Prentice-Hall Memorandum T.C. (1950).

[37] Footnote 34, above. But see *Hadwen C. Fuller,* 21 T.C. 407 (1953); *Estate of Morris H. Cone,* par. 54,162 Prentice-Hall Memorandum T.C. (1954).

[38] *Commissioner* v. *Smith* (2 Cir. 1953), 203 F. 2d 210, 43 AFTR 675, reversing 17 T.C. 135 (1951).

Avoiding non-business bad debts. Since an individual may have to show that he is in the money-lending business before becoming entitled to business bad debt deductions, it is important to explore methods of avoiding Section 166(d). The first point is to see whether there was in fact a debt or whether there was a loss, which might be fully deductible under Section 165. These sections are mutually exclusive, and to escape Section 166(d) the individual must establish that no debtor-creditor relationship existed or else that the loss was occasioned by something other than the debtor's inability to pay. Even though the stockholder did not make the loan to the corporation himself but only guaranteed a third party's loan, the loss might not be deductible, for ordinarily payment under the guaranty gives rise to a debt claim against the debtor and so the loss becomes one from a bad debt. However, some courts have held that payment under the guaranty does give rise to a loss and not to a bad debt when the corporate debtor is insolvent.[39] Nevertheless, for an individual to deduct a loss under Section 165, the loss must have been incurred either in a trade or business, or in a transaction entered into for profit, or else by reason of a casualty.

If the Tax Court's position that a "promoter" may be engaged in a trade or business should be generally sustained, then a stockholder may improve his position by establishing a legal relationship with the corporation, separate and distinct from the stockholder relationship, and make his loans by reason of that other relationship, as in the *Spencer* case.[40] He may then be able to persuade a court that the loans are made in the course of his individual business and so give rise to business, rather than non-business, debts.

Worthless securities. Different treatment is accorded worthless securities, defined in Section 165(g)(2) as meaning a share of stock in a corporation; a right to subscribe for or receive stock; and a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. If the security is a capital asset (and that will be so for all except dealers in securities), then for the year in which the security becomes wholly worthless, the loss must be treated as one realized from the sale or exchange of a capital asset on the last day of the taxable year. The capital loss, therefore, may be long- or short-term, depending upon the period for which it was held. No deduction for partial worthlessness is allowed.

Affiliated corporations. This limitation for worthless securities applies to both individual and corporate creditors. However, the limitation is inapplicable to securities held by certain corporate creditors who are "affiliated" with the debtor-corporation.[41] In that case, the capital loss limitation is not applicable, and the bad debt may be deducted in full, but no deduction for securities which are only partially worthless is allowed.[42] Section 165(g)(3) provides that a debtor is to be considered "affiliated" only if three conditions co-exist: (1) at least 95 per cent of each class of its stock is owned directly by the creditor; (2) more than 90 per cent of the aggregate of its gross receipts[43] *for all taxable years* has been from sources other than royalties, rents (other than from rental of property to employees in the ordinary course of its operating business), dividends, interest (other than on deferred purchase price of operating assets sold), annuities, or gains from sales or exchanges of stocks and securities; and (3) the creditor is a domestic corporation.

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[39] *Pollak* v. *Commissioner* (3d Cir. 1954), 209 F. 2d 57, 45 AFTR 93, reversing 20 T.C. 376 (1952); *Allen* v. *Edwards* (D.C. M.D. Ga. 1953), 114 F. Supp. 672, 44 AFTR 425, affd (5 Cir. 1954) 216 F. 2d 794. The Tax Court has held to the contrary. *George Aftergood,* 21 T.C. 60 (1953); *Peter Stamos,* 22 T.C. 885 (1953). Even the Tax Court agrees that the payment may be deducted if the corporate debtor is then no longer in existence. *Abraham Greenspon,* 8 T.C. 131 (1947); cf. *William B. Cudlip,* par. 53,355 Prentice-Hall Memorandum T.C. (1953), reversed on other grounds, (6 Cir. 1955) 220 F. 2d 565. See also *Fox* v. *Commissioner* (2d Cir. 1951), 190 F. 2d 101, 40 AFTR 953. Section 166(f) of the 1954 Code establishes this rule by statute in the case of payments by individuals as a guarantor, endorser or indemnitor of a *noncorporate* obligation. It apparently was not intended to cast any implication as to the results in the field of this chapter. S. Rep. No. 1622, 83d Cong., 2d Sess. p. 200.

[40] *Maloney* v. *Spencer,* footnote 34, above.

[41] Section 165(g)(3) of the 1954 Code.

Distributions in liquidation by a subsidiary. Distributions by a subsidiary corporation to a parent in satisfaction of indebtedness to the parent are not affected by Section 332 of the 1954 Code (Section 112(b)(6) of the 1939 Code), which applies only to distributions by the subsidiary to the parent in cancellation or redemption of stock. If all the subsidiary's assets are distributed to its parent, they will be considered applicable first to the satisfaction of the subsidiary's debt.[44] Therefore, when the subsidiary's assets which are distributed to the parent are insufficient to pay its debts in full, a bad debt loss will be available to the parent with respect to the unpaid amount.[45] The same result is reached although the transaction is cast in the form of a "sale" of assets to the parent in consideration of its assumption of the subsidiary's liabilities.[46] On the other hand, a parent may realize a gain on receipt of a subsidiary's assets in satisfaction of obligations acquired by the parent at a discount.[47]

Consolidated returns. If the parent and subsidiary file consolidated returns, the right to a bad debt deduction is governed by the consolidated return regulations.[48] Under Section 1.1502-40 of the Income Tax Regulations, no deduction is allowed during a consolidated return period to any member of the affiliate group on account of complete or partial worthlessness of any obligation of another corporation, which was a member of the group on the last day of the taxable year or was liquidated during the year, except as a loss resulting from the bona fide termination of the business and operations of such other corporation, in liquidation or otherwise. The requirements for reduction of basis of intercompany obligations in case of the sale of such obligations[49] are applicable to bad debt losses, as are the limitations on the allowability of such losses.[50] The basis reduction provisions are also applicable in the case of a bad debt loss sustained subsequent to the consolidated return period.[51]

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[42] Reg. 118, § 39.23(k)-4.

[43] For this purpose, gross receipts from sales or exchanges of stocks or securities include only the gains therefrom. The 1954 Code changed the requirement to 90% of gross receipts rather than 90% of gross income.

[44] See *W. D. Haden Co.* v. *Commissioner* (5 Cir. 1948), 165 F. 2d 588, 36 AFTR 670.

[45] *Edward Katzinger Co.*, 44 B.T.A. 553 (1941), affirmed on other grounds (7 Cir. 1942), 129 F. 2d 74, 29 AFTR 783; *H. G. Hill Stores, Inc.*, 44 B.T.A. 1182 (1941). The Commissioner acquiesces. 1942-2 C.B. 9. See also *Iron Fireman Mfg. Co.*, 5 T.C. 452 (1945).

[46] *Fairbanks, Morse & Co.* v. *Harrison* (D.C., Ill., 1945), 63 F. Supp. 495, 34 AFTR 749.

[47] *Houston Natural Gas Corp.* v. *Commissioner*, footnote 13, above.

[48] See Reg. 129, § 24.31(d)(11).

[49] Reg. § 1.1502-35. See *Charles Ihlfeld Co.* v. *Hernandez*, 292 U.S. 62; 13 AFTR 881 (1934).

[50] Reg. § 1.1502-40(a).

[51] Reg. § 1.1502-40(b); *Bush Terminals Bldgs. Co.*, 7 T.C. 793 (1946).

8. Effect of Gratuitous Cancellation on the Creditor

The questions arising in this field are troublesome and largely unanswered. What are the tax consequences when a stockholder-creditor gratuitously forgives his debt? It has been decided that the creditor does not realize taxable income from cancellation of the debt.[52] However, liability for gift tax may result. The legislative history of the gift tax statute clearly points out this possibility.[53] Nevertheless, a transfer will be deemed to be made for an adequate and full consideration in money or money's worth, and therefore not a taxable gift, if "made in the ordinary course of business . . . *bona fide*, at arm's length and free from any donative intent." [54]

Where a creditor, as a result of arm's length bargaining in the ordinary course of business and without donative intent, accepts less than full consideration in settlement of his claim, he would not incur a gift tax, having met the requirements of the Regulation, even though he was a stockholder.[55] Furthermore, the unrecovered portion probably would be valueless and so not subject to gift tax. The fact that the creditor was a stockholder, however, would have a bearing on the creditor's intent with respect to the cancellation. More probably, the stockholder, rather than bargaining for consideration, will be willing to forego collection of his debt in return for expected indirect benefits either to himself or to the other shareholders.

If a creditor who is sole stockholder cancels the corporation's debt, he can expect correlative benefits to himself as stockholder. The same would be true if debts were owing to all stockholders in proportion to their stockholdings and all of the debts were gratuitously cancelled. In these cases, it is clear that the corporate debtor has no income because the cancellation is characterized as a "contribution to capital." [56] And, although in a sense "contribution" means the same as "gift," a contribution to capital of this type cannot be deemed a taxable gift, for it is primarily impelled by the business considerations favoring the exchange of a creditor's interest for an increased interest as a stockholder.[57]

Gift tax. If the creditor is only one of several stockholders, cancellation of his debt may well give rise to a taxable gift, particularly if the other stockholders were the natural objects of his bounty. Clearly, the cancellation would inure only partly to the creditor's benefit; inevitably part of the benefit would inure to the other stockholders' benefit. When this necessary result can be coupled with an indication that the creditor's motive was, at least in part, to benefit the other stockholders, the ingredients for a taxable gift are present. The amount of this gift is the value of the property transferred, i.e., the value of the cancelled debt at the time of cancellation. If the debt is then partially worthless, and is a business bad debt not evidenced by a security, the creditor is presumably entitled to a bad debt deduction for the worthless portion.

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[52] See *John Harvey Kellogg*, 2 T.C. 1126 (1943) (acquiescence, 1944 C.B. 16), wherein the taxpayer, on the cash basis, gratuitously waived his right to unpaid salary. Cf. Rev. Rul. 45, 1953-1 C.B. 178.

[53] H. Rep. No. 708, 72d Cong. 1st Sess., p. 28. Cf. Reg. 108, § 86.2.

[54] Reg. 108, § 86.8, approved in *Commissioner* v. *Wemyss*, 324 U.S. 303, 33 AFTR 584 (1945).

[55] It would seem that the debtor would realize taxable income under the *Jacobson* decision.

[56] Reg. 118, § 39.23(a)-13.

[57] See *Emily Coles Collins*, 1 T.C. 605 (1943), where the sole preferred stockholder, who waived her right to dividend arrearages, was held not subject to gift tax even though the common stock was owned by her and her children. This case may have been weakened by the Supreme Court decision in *Commissioner* v. *Wemyss*, footnote 54, above, which held that donative intent was not an essential element of a taxable gift.

Identity of donee. If a gift tax liability is incurred, is it a gift to the corporation or to the other stockholders? The answer to this question is necessary to determine the number of annual exclusions available, and perhaps even to compute the amount of the gift. The answer is still in doubt. The legislative history of the gift tax statute indicates that the gift is to the other stockholders but, on the other hand, the case law indicates that the gift is to the corporation. The Congressional committee reports on the 1932 Revenue Act state that "a transfer by A to a corporation owned by his children would be a gift to his children," [58] whereas the *Thompson*[59] and *Heringer*[60] cases hold and the *Scanlon*[61] case suggests that the gift is to the corporation as an entity. Whatever may be the ultimate answer with respect to the number of annual exclusions, the amount of the gift should be determined by excluding that proportion of the fair value of the debt cancelled which the stockholdings of the creditor bear to the total outstanding stock, since there is consideration for the cancellation to the extent of the creditor's equity interest.[62]

Basis of stock. There are also problems as to the consequences of a cancellation on the basis of the creditor's stock and also the stock of other stockholders. The answers appear to depend upon the character of the transaction.

If the creditor is seeking the greatest possible recovery on his debt, he would seem entitled only to a bad debt deduction and not to any change in basis. But if the creditor is a sole stockholder, the cancellation of his debt calls for an increase in basis, as a contribution to capital [63] measured by his basis for the property contributed, i.e., the debt.[64] The same would be true if all stockholders contribute debt in proportion to their stockholdings.[65]

If the creditor's cancellation constitutes a gift to other stockholders, the creditor's basis should not be increased by more than that proportion of the debt's basis which his stockholdings bear to the total stock outstanding, since the creditor is giving away to others the remainder of the debt. It is not clear that the creditor in this situation will be allowed any increase in basis. The other stockholders, as donees, might expect to have a proportionate increase in basis. However, it has been held, in the case of a trust-stockholder, that no increase in basis was warranted where a contribution to the corporation was made by the settlor.[66] The Board of Tax Appeals rejected the argument that the contribution was in part a gift to the trust as stockholder, and the Second Circuit held that the trust's shares were limited to its donee's basis at the time the shares were transferred.

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[58] H. Rep. No. 708, footnote 53, above; S. Rep. No. 665, 72d Cong. 1st Sess., page 39. The Regulations state that a transfer of property by a corporation to B is a gift from the stockholders. Reg. 108, § 86.2. See also *Diebold* v. *Commissioner* (3 Cir. 1952), 194 F. 2d 266, 41 AFTR 698.

[59] *Frank B. Thompson*, 42 B.T.A. 121 (1940), remanded pursuant to stipulation (6 Cir. 1942).

[60] *Stephen F. Heringer*, 21 T.C. 607 (1954).

[61] *Robert H. Scanlon*, 42 B.T.A. 997 (1940). The Board observed that a transfer of property to a corporation by a stockholder would benefit the others proportionately but that administrative practicalities might require treating it as a transfer to the corporation as an entity.

[62] It must be admitted that the *Heringer* case, note 60, *supra*, clearly holds otherwise, but the amount of a loss sustained upon surrender of stock to a corporation takes this factor into account. *Payne Housing Corp.*, par. 54,190 Prentice-Hall Memorandum Decisions (1954); *Estate of William H. Foster*, 9 T.C. 930 (1947).

[63] See Section 1016(a)(1)(A) of the 1954 Code (Section 113(b)(1)(A) of the 1939 Code). The property whose basis is to be adjusted for the additional equity investment is the creditor's stock.

[64] *Hughes Tool Co.* v. *Commissioner* (5 Cir. 1941), 118 F. 2d 472, 26 AFTR 722; Section 362 of the 1954 Code provides that the basis of property acquired by a corporation as a contribution to capital shall be the transferor's basis, adjusted for recognized gain or loss.

[65] See *Kasle* v. *United States* (D.C. Ohio, 1947), 75 F. Supp. 340, 36 AFTR 1214.

Steps to take. The difficulties in this area are particularly troublesome for all except sole stockholders, and they should be avoided if possible. Probably, the most satisfactory way for all parties to handle a cancellation of debt by a stockholder is to treat it as a contribution to capital, spelling out in letters and corporate minutes the intent of the creditor and debtor that the cancellation take place in order to strengthen the capital of the corporation for the ultimate benefit of the stockholder. If this expression sufficiently accords with the facts, then the stockholder may not have made a gift and may get an increase in basis and the corporation probably will realize no income.

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[66] *Forrestal* v. *Commissioner* (2 Cir. 1941), 120 F. 2d 223, 27 AFTR 413, affirming 41 B.T.A. 1080 (1940). Cf. *Weeks* v. *White* (1 Cir. 1935), 77 F. 2d 817, 16 AFTR 189.

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Acquiring and Disposing of Treasury Stock

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Treasury stock has been defined as "shares of the capital stock of a corporation which have been legally issued and have thereafter been acquired by the corporation and have not been formally retired."[1] The definition evokes no dissent; it accords nevertheless a point of departure for emphatically divergent opinions on the fundamental legal and accounting nature of the subject defined. At the base of conflicting lines of authority in construction tax-wise of treasury stock transactions is the unresolved controversy whether such "reacquired stock, like unissued stock, represents merely a method or possibility of raising capital rather than an actual resource"[2] or, on the contrary, retains en route to and in the hands of the reacquiring corporate issuer, and thereafter uninterruptedly pending legal retirement, an asset status indistinguishable from that of any other security or investment. The tax consequences are apt to vary widely according as the one thesis or the other be held controlling in a given set of circumstances. To what discernible criteria may taxpayers look for guidance in appraising the prospective tax impact of those transfers which give rise to treasury stock initially, as well as of those which transmute it, through reissue, into its former "outstanding" classification?

1. Points to Consider

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[1] W. A. Paton, *Accountants' Handbook*, page 1007. New York: The Ronald Press Company, 1944.

[2] *Op. cit.*, page 1008.

I

CORPORATE ACQUISITION

Genesis of Treasury Stock

A corporation's acquisition of shares of its previously issued and outstanding stock may be by way of gratuitous receipt, in the form of *inter vivos* gift (in whole or in part) or testamentary bequest; through investment yield; or pursuant to a consideration-supported exchange. What tax potentialities may emerge from these diverse routes of movement from stockholder to the corporate "treasury"?

2. Gift or Bequest

The incidence of income tax liability would not appear to threaten the corporate recipient of donated or bequeathed shares of its own stock, the acquisition being no less within the statutory exemption[3] than similar devolution of other forms of property upon individual donees and legatees.

Whether or not and in what manner, however, the provisions of the gift tax statutes[4] may be applicable to an *inter vivos* donation in such medium depends, in the final analysis, on the relative persuasiveness of the mutually opposed concepts of treasury stock: is it no more than a capital-raising *potential*, in a state of suspended animation, as it were, or is it no less actual existent *property* than, for instance, a government bond or comparable form of investment? A gratuitous transfer of property to the corporation by a stockholder (other than a sole stockholder)[5] has been held a taxable gift to a single donee, regardless of the number of other stockholders, thus occasioning allowance of only one annual exclusion.[6] Suppose, then, that the gratuity take the form of shares of the transferee corporation's own stock? The Tax Court had to deal with a close approach to such a situation in the case of *Emily Coles Collins*,[7] involving formal waiver of dividend arrearages on cumulative preferred stock by the sole holder thereof, who owned additionally 25 per cent of the common, the remaining 75 per cent being owned equally by her three adult children. The Commissioner contended unsuccessfully for construction of the transaction as a taxable gift, with allowance of but one annual exclusion. The majority of the Court found that sound justifying business reasons predominated over donative intent[8] and, more important, professed inability to discern any true property transfer at all. A two-judge dissent would have upheld the Commissioner, allowing however, three annual exclusions, on the theory that the other common stockholders, rather than the single corporate entity, were the actual donees. On appeal to the Third Circuit the decision was vacated by stipulation in compromise, without further report.[9]

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[3] 1954 IRC § 102; 1939 IRC § 22(b)(3).

[4] 1954 IRC Ch. 12, Ch. 64C; 1939 IRC Ch. 4. Note contingent donee liability, Section 6324(b) and Section 1009, respectively.

[5] *Robert H. Scanlon*, 42 B.T.A. 997 (1940) (A).

[6] *Frank B. Thompson*, 42 B.T.A. 121 (1940) (rem'd because of compromise, 6 Cir. 2-4-42). Accord, *Stephen F. Heringer*, 21 T.C. 607 (1954) (now on appeal in Ninth Circuit).

[7] 1 T.C. 605 (1943) (NA).

[8] "Donative intent" is no longer a prerequisite to gift tax liability. *Commissioner* v. *Wemyss*, 324 U.S. 303, 33 AFTR 584 (1945).

In the *Collins* case, of course, the transfer to the corporation was of certain rights inherent in the stock, rather than of the stock itself, but the Commissioner's contention would seem as logically applicable to the one as to the other. In the later *Fulton* cases[10] before the Tax Court, involving a corporation's cash purchase of a portion of its outstanding stock, gift tax liability was urged with respect to the alleged excess of the fair market value thereof over the price paid by the corporation, but to no avail; the Court was again persuaded by the clear subordination of any possible donative intent to compelling business reasons for the transaction and, as a clincher, was unwilling to find, as a matter of fact, that the negotiated price deviated from a theoretical fair market value, howsoever much it appeared to be under current book value.

Except for the Tax Court's suggested distrust in the *Collins* case of the "investment asset" concept of treasury stock, both the *Collins* and the *Fulton* decisions may be said to have been in large measure governed respectively by their peculiar distinguishing facts. Apparently unchallenged in the latter, however, is the government-urged theory that gift tax liability may arise from a stockholder's transfer of shares to the corporation for a consideration less than the fair market value thereof—notwithstanding that the stockholder may simultaneously have incurred income tax liability measured by the excess of such consideration over the *basis* of the transferred shares. It is not without further significance that the Commissioner adopted in the *Fulton* cases the point of view of the dissent in the *Collins* case, to the extent of calculating the number of gifts, and therefore the allowable annual exclusions, by the number of non-transferring holders of common stock; from such development might well be inferred official adoption, for gift tax purposes, of a basic distinction between gratuitous transfers to a corporation of shares of its own stock, on the one hand, and of other subjects of property, on the other—recognizing a single donee in the latter situation,[11] possibly multiple donees in the former. The later *Diebold* case[12] makes the distinction boldly.

In *Diebold*, the controverted issue was one of *basis*. The owner of one-eighth of the stock in a family corporation died and bequeathed *to the corporation* all his shares of stock, in addition to miscellaneous tangible property items. On a subsequent sale of stock by one of the surviving shareholders, also a one-eighth owner at the time of the bequest to the corporation, he successfully contended for upward adjustment of the basis of his holdings by reason of such bequest. The allowable adjustment was held by the Court to be one-fifty-sixth ($1/7$ of $1/8$) of the current net worth of the corporation as of the date of the testator's decease, unenhanced, however, by the value of property *other than its own stock* which devolved on the corporation under the will. Of such latter form of bequest, as in the case of the *Thompson*[13] *inter vivos* transfer, the corporate entity itself was held the direct and immediate beneficiary, receiving a measurable increment in its operating resources, whereas its receipt of its own shares added naught to its working capital and effected nothing beyond a shift of equities *as between individual* shareholders, who alone may properly be said to comprise benefactor and beneficiaries in the transaction.

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[9] Prentice-Hall *Estate and Gift Tax Service*, § 126164, indicating that applicability of the Gift Tax provisions to the dividend arrearages waiver was conceded.

[10] *Barbara S. Fulton et al*, T.C. Memo. Docket No. 16037, No. 16038, par. 49,110 Prentice-Hall Memorandum T.C. (1949).

[11] Footnote 6, above.

[12] *Diebold* v. *Commissioner* (3 Cir. 1952), 194 F. 2d 266, 41 AFTR 698. (considered on remand with respect to tangible property bequest, par. 53052 Prentice-Hall Memorandum T.C. (1953).)

Under the rationale of the *Diebold* decision, therefore, a gift or bequest to a corporation of shares of its own stock, as differentiated from like transfers of other forms of property, is to be construed tax-wise as a telescoped two-step transaction: *pro rata* transfer to other stockholders, followed immediately by their proportionate contribution to the commonly owned corporate capital. Such a construction not only operates to multiply allowable annual exclusions, but it also protects the corporation from the specter of contingent donee liability.[14] Doubtless further chapters remain to be written in this department of tax law.[15] Meanwhile, however, generously disposed stockholders in closely held corporations would be well advised to avoid the necessity of resort to the *Diebold* construction, to choose ab initio as the direct object of their benefactions in corporation stock, not the corporation itself, but their fellow shareholders instead. It is expensive even to *win* a tax case.

3. Investment Yield

According to at least one holding squarely in point,[16] transfer by a wholly owned subsidiary to its parent corporation, without consideration, of shares of the parent's stock, acquired some years previously by the subsidiary in the open market, constitutes no less a taxable dividend to the parent than a distribution in any other medium. It was argued to the Court in vain that the parent's receipt of its own shares not only did not enhance its resources but indeed brought to it nothing whatsoever that it did not already effectively possess through sole ownership of the subsidiary. The argument was dismissed as an unwarranted disregard of the legal separateness of the corporate entities. The Court seemed unqualifiedly to espouse the "investment asset" concept of treasury stock, as opposed to that of "suspended animation": if the parent's stock be property in the subsidiary's hands, it is no more metamorphosed into something-less-than-property in the transition than would be the shares of an "outsider" corporation.

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[13] Footnote 6, above.

[14] Footnote 4, above.

[15] Section X1090 of the American Law Institute's Tentative Draft No. 8 (May 8, 1953) on Federal Income, Estate and Gift Tax Statute, would make the *Diebold* holding applicable to *every* form of gratuitous transfer of property to a corporation "of Limited Ownership." There is brief but (to this writer) logically questionable authority for the proposition that a stockholder's contribution of a portion of his shares to the corporation, instead of involving *gift* tax consequences, affords the contributor a deductible ordinary loss for *income* tax purposes in the amount of the basis of the surrendered shares diminished by the book value increment of the retained shares. *Julius C. Miller*, 45 B.T.A. 292 (1941) (A). The Board reached such conclusion by extension of the quite distinguishable doctrine of *George M. Wright*, 18 B.T.A. 471 (1929), modified on appeal (7 Cir. 1931) 47 F. 2d 871, 9 AFTR 1031; *City Builders Finance Co.*, 21 B.T.A. 800 (1930) (NA); *Peabody Coal Co.* v. *U.S.* (Ct. Cls. 1934), 8 F. Supp. 845, 14 AFTR 1042; and *Commissioner* v. *Burdick* (3 Cir. 1932), 59 F. 2d 395, 11 AFTR 513—all instancing share transfers, *not* to the corporation, but to third parties in consideration of the transferees' undertaking to bolster the corporation's financial condition through extension or continuation of credit, provision of needed managerial services, or payment of its debts. But Miller's contribution to the corporation of 200 of his 550 shares (760 were outstanding) did not operate to increase the $60,881.63 of net assets by one penny or in any way otherwise enhance the financial strength of the corporate venture; instead of sustaining an adjudged $9,822 loss, he simply made a gratuitous transfer of $6,008 book equity to the minority stockholders, whatsoever may have been the motive or the ensuing developments. The *Miller* decision is cited approvingly and purportedly followed by *William H. Foster Estate*, 9 T.C. 930 (1947) (A) (but the facts on analysis appear to be essentially those of the *Burdick* case), and the recent holding of *Payne Housing Corporation*, T.C. Memo. 1954-85, is in accord. Nevertheless, authoritative appellate court discussion of the precise point decided in *Miller* would seem required to fortify its reliability.

[16] *Golden State Theatre & Realty Corporation* v. *Commissioner* (9 Cir. 1942), 125 F. 2d 641, 28 AFTR 1119.

The cited decision antedated by some six years that of the *Rodman Wanamaker Trust*,[17] which exempted from the applicability of 1939 IRC § 115(g) (1954 IRC § 302(b)(1)) a stockholder's sale of a parent corporation's shares to that parent's wholly owned subsidiary. Congress proceeded in 1950 to close the exposed loophole by the addition of Section 115(g)(2) to the Code (1954 IRC § 304). The *Golden State Theatre* case should properly be re-read in the light of that enactment. If now the event of taxability of the transferring stockholder under the cited Code provision be his sale to the subsidiary, in like manner as though the subsidiary had first distributed property to the parent and the parent had applied same to redemption of its shares, does it not follow logically that the parent received a constructive, but no less taxable, dividend from the subsidiary *at that time*, which it simultaneously employed to redeem its own shares? If so, how can such parent be again taxable on the occasion of the subsidiary's later transfer of the shares which, for tax purposes, the parent is construed to have redeemed long since?

Thus Congressional action in the interim may very well have rendered the *Golden State Theatre* holding obsolete. Whether or not, when, and to what extent a parent corporation may experience income tax impact from a subsidiary's dealings in the parent's stock are questions which still await clarifying answer.

4. Purchase

As a general rule, the transfer of a commodity for value does not give rise, in and of itself, to any income tax liability on the part of the buyer. How safely does that generalization apply to a corporation's purchase of shares of its own stock?

No shadow of tax peril or benefit seems to fall athwart the corporate taxpayer's course if it simply buys its shares with cash or cash media, thereby accounting pro tanto in dollars for the seller's ratable part of the common venture equity.[18] A

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[17] 11 T.C. 365 (1948), aff'd without opinion in Third Circuit (1949), 178 F. 2d 10.

[18] *Hutchins Lumber & Storage Co.*, 4 B.T.A. 705 (1926) (A in part, NA in part); *Johnson* v. *Commissioner* (5 Cir. 1932), 56 F. 2d 58, 10 AFTR 1264, cert. den. 286 U.S. 552; *Jewel Tea Co.* v. *U.S.* (2 Cir. 1937), 90 F. 2d 451, 19 AFTR 852. But if the corporation should buy shares of its own stock from a *subsidiary* and pay less than the determined fair market value thereof, it could well be construed, in the combined light of *Timberlake* v. *Commissioner* (4 Cir. 1942), 132 F. 2d 259, 30 AFTR 583, and *Golden State Theatre & Realty Corporation* v. *Commissioner*, footnote 16, above, as having received a taxable dividend in the amount of the "bargain."

Worthy of note in this connection is the decision of *Patent Button Co.* v. *Commissioner* (2 Cir. 1953), 203 F. 2d 479, 43 AFTR 698, in which the taxpayer corporation contended that problem arises, however, where consideration to the vending stockholder is embodied in other conceivable forms: has the corporation consummated a true purchase or, contrariwise, should the transaction be construed as a corporate disposal of an asset, realizing in exchange therefor shares of its own stock, in lieu of cash or other property? As early as 1928 the Board of Tax Appeals decided in favor of the latter construction and sanctioned deduction of loss sustained by the corporate taxpayer in its transfer of certain securities to a stockholder at an agreed figure (less than basis), the proceeds of sale being charged against the amount due to the stockholder as consideration for simultaneous purchase of all his stock.[19] To the holding it adhered[20] until the decision of the *Houston Brothers Co.* case,[21] involving alleged realization of taxable gain by the corporation upon a transfer of property for shares of its own stock; *Behlow Estate* and *N. J. Porcelain Co.* were expressly disapproved, the majority of the Board[22] concluding that a stock redemption is not converted into an exchange of property by corporate use of a medium other than cash in effecting it: "a corporation's own shares are not assets, but only the convenient machinery for evidencing stockholder interests," in the corporation's receipt of which "it is a fallacy to say it has received anything and *a fortiori* that it has received a gain."

On the same day that it decided *Houston Brothers Co.* the Board disposed similarly of *S. A. Woods Machine Co.*,[23] with six recorded dissents. The latter case was destined to become a landmark in this field of tax law. The taxpayer corporation had recovered a decree in a patent infringement suit; pending determination of the money damages it accepted in full satisfaction approximately a third of its then authorized and outstanding shares, promptly retiring the stock so acquired, worth at market over $400,000. On appeal from the Board's rebuff, the Commissioner was sustained[24] in his contention that taxable income in such amount was realized, no less so than had the corporation first collected the equivalent cash and thereupon used it in purchase of the stock. Indeed, said the Court, "the stock was the medium in which the debt was paid."

S. A. Woods Machine Co. was promptly adopted as authority in taxing the

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its cash payment to a salaried executive, in purported repurchase of shares of its stock sold to him on credit in a prior year when same were worth considerably less, constituted nothing more than deductible extra compensation; the Court held otherwise, construing the transaction in accordance with the form in which it was cast and disallowing the claimed deduction for what was in substance, as well as in form, simply the purchaser's cost of the reacquired shares.

The corporation's purpose motivating purchase of its shares may later become a legitimate subject of inquiry in appraising the tax consequences of subsequent sales thereof. See Section 8, 4, hereinafter. Consider also *New Hampshire Fire Insurance Co.*, 2 T.C. 708, 723-4 (1943), aff'd (1 Cir. 1945) 146 F. 2d 697, 33 AFTR 426, in which it was held that the cash amount which the corporation paid in excess of market value for its stock represented discharge of a moral obligation and should be excluded from the cost of the shares in computing gain or loss on subsequent sale and reissue.

[19] *Behlow Estate*, 12 B.T.A. 365 (1928) (NA).

[20] *N. J. Porcelain Co.*, 15 B.T.A. 1059 (1929) (NA), involving a corporation's sale of land and buildings for cash, some of its own stock, and a mortgage; accord, *Walville Lumber Co.* v. *Commissioner* (9 Cir. 1929), 35 F. 2d 445, 8 AFTR 9734, and *Spear & Co.* v. *Heiner* (D.C., W.D. Pa. 1931), 54 F. 2d 134, 10 AFTR 829.

[21] 21 B.T.A. 804 (1930) (A).

[22] Seven judges joined in a written dissent.

[23] 21 B.T.A. 818 (1930).

[24] *Commissioner* v. *S. A. Woods Machine Co.* (1 Cir. 1932), 57 F. 2d 635, 11 AFTR 25, cert. den. 287 U.S. 613.

corporation upon acceptance of shares of its own stock in satisfaction of a debt previously charged off and allowed as a loss deduction[25] and in allowing deduction of the loss sustained by a corporation in its exchange of certain investment securities for shares of its own stock.[26] More importantly, much of the language of the appellate Court opinion was imported bodily into T.D. 4430, promulgated on May 2, 1934, which has been perpetuated in Reg. 118, § 39.22(a)-15.[27] Thus fortified, *S. A. Woods Machine Co.* has become in due course the bellwether of a respectable line of authority, unqualified adherence appearing in the Third,[28] Fifth,[29] and Sixth[30] Circuits.

Thus authoritatively established is the basic proposition that a corporation's acquisition of shares of its own stock, either in exchange for non-cash assets or in complete or partial satisfaction of a chose in action, is prima facie the occasion of its realization of taxable income (or gain) or deductible loss, as the case may be, to the extent of the "spread" between the fair market value of its stock so acquired and the basis of the item or items yielded up or extinguished in exchange—regardless of whether the stock be thereupon promptly retired or thereafter retained in the corporate "treasury." The proposition rests upon construction of the transaction as the sale of an asset or the collection of a receivable, the medium of realization simply taking the form of stock rather than the more usual form of cash or notes.[31]

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[25] *Houghton & Dutton Co.*, 26 B.T.A. 52 (1932). Accord, *C. G. Meaker Co.*, 16 T.C. 1348 (1951): corporation's receipt of its own stock in consideration of a ten-year lease of certain premises.

[26] *Niagara Shoe Corporation*, 30 B.T.A. 668 (1934).

[27] "(a) Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.

"(b) However, if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Internal Revenue Code."

[28] *Commissioner* v. *Boca Ceiga Development Co.* (3 Cir. 1933), 66 F. 2d 1004, 12 AFTR 1332, rev'g 29 B.T.A. 1428—gain on sale of land.

[29] *Dorsey* v. *Commissioner* (5 Cir. 1935), 76 F. 2d 339, 15 AFTR 1107, cert. den. 296 U.S. 589—gain on sale of building; *Hammond Iron Co.* v. *Commissioner* (5 Cir. 1941), 122 F. 2d 4, 27 AFTR 784, rev'g 41 B.T.A. 86—loss on sale of miscellaneous assets; *Trinity Corporation* v. *Commissioner* (5 Cir. 1942), 127 F. 2d 604, 29 AFTR 352, aff'g 44 B.T.A. 1219, cert. den. 317 U.S. 651—gain on sale of building.

[30] *Allyne-Zerk Co.* v. *Commissioner* (6 Cir. 1936), 83 F. 2d 525, 17 AFTR 1157, aff'g 29 B.T.A. 1194—gain on sale of all tangible assets.

[31] A factor strengthening the "asset sale" construction, as opposed to the "redemption" construction, in each of the *Boca Ceiga Development Co., Dorsey, Trinity Corporation,* and *Allyne-Zerk Co.* cases was the corporation's receipt of cash and/or cash items, *in addition to* shares of its own stock, by way of payment for the property disposed of to the stockholder.

Query: does a corporation realize taxable income, under the considered doctrine, upon its exchange of an oil payment from producing leases for shares of its own stock? The question was raised at a comparatively recent seminar and answered in the affirmative, despite the absence of authority precisely in point, the realization being deemed ordinary income subject to depletion, per G.C.M. 24849, 1946-1 C.B. 66. See *Oil and Gas Tax Quarterly*, April 1953, Volume II, pages 137-138.

Deviation from the "asset sale" construction is disclosed by two later cases, the taxpayer prevailing in the one, the Commissioner in the other. In *Lencard Corporation*[32] the corporate taxpayer transferred various securities and cash in exchange for all its outstanding preferred stock, whereupon the preferred was retired pursuant to charter amendment reducing the authorized capital; the Board rejected the contention that the excess of the fair market value of the acquired shares over the aggregate basis of the transferred property constituted taxable income, holding that the transaction was "essentially" a partial liquidation, rather than a sale of assets. *Houston Brothers Co.*[33] is not cited, but its rationale seems to pervade *Lencard Corporation*, although, interestingly enough, the author of the latter opinion wrote the dissent to the former. More recently, in *Lucius Pitkin, Inc.*,[34] the Tax Court disallowed deduction of a loss claimed by the taxpayer corporation to have been sustained upon its exchange of miscellaneous assets for one-third of its outstanding common stock, being the entire holdings of a withdrawing executive—the shares so acquired were forthwith distributed as a dividend to the two remaining common stockholders. Held to be controlling, in lieu of § 39.22 (a)-15 of the Regulations, was the provision in § 39.22 (a)-20 that "no gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition." "Under either regulation," states the Court, "we are to determine the *real nature* of the transaction involved." (italics supplied)

In short, therefore, the judicially determined "real nature" of the transaction is the key to solution of the question. Do all the relevant factors point to a partial liquidation, a pro tanto redemption of outstanding equity, in which the use of non-cash corporate assets figures but incidentally and with relatively subordinate significance? If so, the corporation so acquiring shares of its own stock experiences no income tax effect, either beneficial or detrimental. But do they, on the contrary, point predominantly to disposal of an asset or collection of a receivable, in consummation of which the vendee or debtor has been allowed to meet his obligation by use of shares of the vendor's or creditor's stock, rather than cash? In such event, the resulting treasury stock affords the measure of taxable increment or deductible loss to the corporate recipient.

In such a transfer for value, whether the transaction vis-à-vis the corporation be construed liquidating distribution or property sale, the provisions of the income tax law impinge on the transferring stockholder no less than upon his transferee. Consideration of the varied problems confronting him, which arise in the main under 1954 IRC § 302, 1939 IRC § 115 (g), represents the subject of other chapters[35] and, accordingly, is not undertaken in this immediate connection. Brief reference will be made, however, to the curious tax implications for the *non-transferring* stockholders from the theory urged upon the Tax Court by the Commissioner in the *Fred F. Fischer* case:[36] Dissension having arisen among the stockholders of a family corporation, a disaffected sister's 250 shares (out of an outstanding 2250) were, after considerable bargaining, bought by the corporation at

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[32] 47 B.T.A. 58 (1942) (A).

[33] Footnote 21, above.

[34] 13 T.C. 547 (1949).

[35] See "Distributions in Redemption of Stock" and "Buying Out a Stockholder," at pages 822 and 839.

[36] T.C. Memo Docket No. 8737, par. 47,131 Prentice-Hall Memorandum T.C. (1947).

175 and retired; par was 100, book value 155, fair market value only 86½, the sister's asking price 275; the Commissioner argued that a taxable dividend in the amount of the excess of the consideration over fair market value had been distributed to the stockholders *other than the sister*, as having been constructively received and used by them to purchase freedom from her further harassment! The argument failed to persuade the Court, which proceeded to observe that "there is no foundation for an assumption that a corporation would never, in its own interests, pay more than the fair market value of its stock in order to rid itself of a complaining minority stockholder threatening to institute receivership proceedings against it."

II

CORPORATE REISSUE

Fruition of Treasury Stock

During the period of its repose in the corporation's custody treasury stock may be accounted for either as an investment asset or as an offset to shares issued and outstanding. The latter treatment tends, of course, to analogize its status to that of authorized but unissued stock. But whatsoever light the alternative balance sheet presentations may throw on the corporate attitude toward reacquired shares, and whatsoever influence the disclosure may exert on judicial construction of the corporation's prior and subsequent transactions in its own stock, merely holding treasury stock, without more ado, affords a temporary respite from tax repercussions; it is upon the occasion of reissue, in lieu of permanent retirement, that tax consequences are generated. Treasury stock thereupon vanishes as something separately discernible, reaching fulfillment of its potentialities by translation into working capital resources, with correlative circulation dehors the corporation of additional certificates of equity. This closing the cycle not infrequently cues the taxgatherer's reappearance.

5. Distribution as a Dividend

Something of a middle ground between the alternatives of retirement and resale is represented by the distribution of treasury stock as a dividend on then outstanding shares. Mechanical reissue occurs, it is true, but without the accompaniment of increase in corporate assets, so that the immediate practical effect is hardly distinguishable from that of retirement—even though such dividend may involve a pro tanto "freezing" of surplus earnings into permanent capitalization and a consequent reduction of the amount thereafter legally available for current distributions in cash or other property.

It is of course beyond the scope of the present discussion to explore the doctrine of *Eisner* v. *Macomber*[37] and decisions that have followed in its wake. Suffice it to note that Reg. 118, § 39.115-7[38] (in positive implementation of the negatively phrased 1939 IRC § 115 (f)(1), now expanded into 1954 IRC § 305 and fortified by 1954 IRC § 317(a)) assures that a stock dividend otherwise non-taxable is no less so when the distribution be made out of treasury stock rather than out of stock previously unissued. The assurance has been judicially effectuated;[39] for a long time virtually no official effort to qualify it was discerned. In *Lucius Pitkin, Inc.*,[40] where the stock reacquired by the corporation in exchange for certain assets was immediately distributed as a dividend to the remaining stockholders, it does not appear that the issue of taxability of the dividend was even raised. Only of late, in the case of *Joseph P. Schmitt, et ux.*,[41] did the Commissioner manifest a changed attitude and urge the point—with startling but short-lived initial success. In its original opinion the Tax Court would seem to be adopting unqualifiedly the "investment asset" concept of treasury stock, treating it as so fundamentally distinguishable from previously unissued stock that its pro rata distribution to stockholders is necessarily as taxable as any other dividend in kind, e.g., in stock of another corporation. From such extreme position it withdrew in the revised opinion, to conclude that the corporation's distribution of its shares acquired through buying out the majority stockholder, from whom the other stockholders had formerly tried in vain to arrange a direct purchase, was in practical effect as though such other stockholders had actually made the purchase on credit and then obtained from the corporation the cash required to meet their respective commitments; *under all the circumstances*, said the Court, they must be taxed accordingly, in order to circumvent "tax evasion." (This is tantamount to saying that where a taxpayer has available alternative routes to a particular objective, he will be visited with the consequences of that which is most onerous tax-wise, regardless of which route be actually followed, lest he be permitted to succeed in legal tax avoidance; the classic distinction between "avoidance" and "evasion" seemed momentarily to fade from judicial memory). But the Court of Appeals reversed (not without dissent), the majority finding naught in the facts to warrant deviation from strict application of the *Eisner* v. *Macomber* doctrine.

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[37] 252 U.S. 189, 3 AFTR 3020 (1920).

Notwithstanding the ultimate outcome, and even in the light of subsequent Code revision, *Schmitt* cannot be disregarded as a danger signal, portending a measure of hazard in the use of treasury stock for dividend purposes. Permanent legal retirement represents a course less subject to controversy with the Commissioner (who is seldom discouraged by a single defeat); a second charter amendment can always be resorted to for authorization of such additional new shares as may be required for projected stock dividends.

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[38] "A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock which would not otherwise be treated as a dividend shall not be so treated merely because such distribution was made out of treasury stock or consisted of rights to acquire treasury stock."

[39] See *James Kay*, 28 B.T.A. 331 (1933), appeal dismissed 70 F. 2d 1017; *Bruckheimer*, 46 B.T.A. 234 (1942) (originally non-acquiesced, later acquiesced).

[40] Footnote 34, above.

[41] 19 T.C. No. 114 (1953), withdrawn and superseded by 20 T.C. 352 (1953), **reversed** (3 Cir. 1-8-54) 208 F. 2d 819.

6. Sale to Present Stockholder

If treasury stock be sold to one who is already a stockholder, does any tax significance attach to the relation between the price paid and the determined fair market value of the shares?

It is conceivable that the purchasing stockholder's overpayment could represent a gift to the extent of the excess over fair market value, in no less degree than, according to the Commissioner's contention, a stockholder's sale to the corporation for less than fair market value.[42]

An excess of fair market value over the price paid, on the other hand, has been held to constitute dividend income to the purchasing stockholder.[43] Reliance for this conclusion was upon the provisions of Reg. 118, § 39.22 (a)-1(b)[44] and the line of authority stemming from *Palmer* v. *Commissioner*,[45] principally *Timberlake* v. *Commissioner*,[46] which relates to stockholder purchases of property items other than treasury stock. No distinction was perceptible to the Tax Court, which went so far as to observe, notwithstanding the corporation's receipt of $210,000 cash for the treasury stock (sold at original cost), that "it cannot be denied that to the extent of the difference between selling price and market value there was a diminution of the corporation's net worth." This is the "investment asset" concept of treasury stock with a vengeance. Unless one can be persuaded to view treasury stock as *property* in itself, with an inherent value beyond simply its potential for transmutation into usable assets, it is hard to see in the facts of the *Strake* case anything other than a waiver of any and all equitable preemptive rights by one set of common stockholders in favor of another, involving gift tax consequences at most.

Quoted in the *Strake* opinion were both *Eastern Carbon Black Co.* v. *Brast*[47] (which had held taxable as ordinary income to the selling corporation the extent of the "bargain" afforded its stockholder vendee of merchandise) and *Choate* v. *Commissioner*;[48] the latter, citing *Eastern Carbon Black Co.*, made the significant generalization that where there is to be found a substantial "spread" favorable to stockholder vendees of a selling corporation, "the situation is the same as if the company had sold the property to strangers and then distributed to its stockholders an amount of cash equal to that 'spread.'" While it does not appear that the

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[42] See Section 2, above.

[43] *Elizabeth Susan Strake Trust*, 1 T.C. 1131 (1931).

[44] "If property is transferred by a corporation to a shareholder, for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, such shareholder shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of a distribution of earnings or profits taxable as a dividend."

[45] 302 U.S. 63, 19 AFTR 1201 (1937).

[46] (4 Cir. 1942) 132 F. 2d 259, 30 AFTR 583. The doctrine was held equally applicable by *Choate* v. *Commissioner* (2 Cir. 1942), 129 F. 2d 684, 29 AFTR 965, to the bargain issue to common stockholders of rights to buy shares of newly issued second preferred stock (distribution of which as a stock dividend would have been distinguishable from the rule of *Eisner* v. *Macomber* and taxable to distributees).

[47] (4 Cir. 1949) 104 F. 2d 460, 23 AFTR 69.

[48] Footnote 46, above.

Commissioner exploited the possibility in the *Strake* case, the Court seems to be saying that the corporation could very well have been reached for tax on a theoretical capital gain[49] from which it theoretically distributed a taxable dividend in the identical amount!

Thus further emphasized are the snares and pitfalls that beset any effort to route treasury stock back to existent stockholders. In the present state of the law due caution cannot but suggest a decided preference for previously unissued stock in accomplishing any desired proliferation of outstanding shares.

7. Transfer to Employee

A corporation may transfer shares of its own stock to an employee either by way of payment for personal services or in pursuance of a sale for value or in a transaction that represents a blend of both.

A corporation-to-employee transfer as compensation for services rendered by the employee gives rise, according to Reg. 118, § 39.22 (a)-3, to taxable income to such employee in the amount of the then fair market value of the stock; and Reg. 118, § 39.22 (a)-1 prescribes that, "except as otherwise provided in Section 130A" of the 1939 Code (1954 IRC § 421),[50] a bargain sale of any property by employer to employee represents taxable compensation to the extent of the excess of the fair market value of the property over the "amount paid." [51] This has been applied to the permitted bargain purchase of stock by a corporation employee, without distinction as to whether the same be from the treasury or theretofore unissued.[52] But both the Board and its Tax Court successor have managed to conclude otherwise and deny taxability under circumstances in which the amount of the employee purchaser's "bargain" was, as a matter of adjudicated fact, not intended as compensation but, on the contrary, was dictated by other legitimate considerations in the best interests of the corporation.[53]

We may postulate, as a general proposition, that an allowable tax deduction to the corporation is correlative to the taxability of income to the employee in transactions of this sort. Is this generalization subject to exception or qualification?

Where the corporation distributes stock to employees, be it from the treasury or previously unissued, in compensation for services rendered by the distributees, it is entitled to an expense deduction under 1954 IRC § 162(a)(1), 1939 IRC § 23 (a)(1)(A), in the amount of the then fair market value of the distributed stock.[54] The amount of this allowable deduction is similarly determined even though the number of shares be computed, per the corporation's bonus formula, by conversion of the dollar amount of a predetermined percentage of net earnings into stock *at par*, notwithstanding that current fair market value be considerably higher; the deduction is *not* reduced to the dollar figure employed as the first step in the computation.[55]

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[49] See Section 8, below.

[50] With respect to exercise of "restricted stock options," originally provided for by the Revenue Act of 1950, with minor amendments by the Revenue Act of 1951.

[51] The present is a far more categorical provision than the predecessor ruling embodied in T.D. 4879, 1939-1 C.B. 159.

[52] *Albert Russel Erskine*, 26 B.T.A. 147 (1932); *Philip W. Haberman*, 31 B.T.A. 75 (1934), aff'd (2 Cir. 1935) 79 F. 2d 995, 16 AFTR 1355; *Edward J. Epsen*, 44 B.T.A. 322 (1941). Cf. *Mason* v. *Commissioner* (6 Cir. 1942), 125 F. 2d 540, 28 AFTR 1087, aff'g 41 B.T.A. 1287, cert. den. 317 U.S. 657.

[53] *Delbert B. Geeseman*, 38 B.T.A. 258 (1938)(A); *Gordon M. Evans*, 38 B.T.A. 1406 (A); *Norman G. Nicolson*, 13 T.C. 690. (In each of the *Nicolson* case and the *Epsen* case, footnote 52 above, the purchasing employee was also a minority stockholder, but the corporation was held to have dealt with him in the transaction exclusively *qua* employee.) See also, *Commissioner* v. *Lo Bue* (3 Cir. 1955), 223 F. 2d 367.

The case of *Westmoreland Specialty Co.* v. *Burnett*[56] presents an interesting deviation from the foregoing rule. It bears marked resemblance in its facts to *Lucius Pitkin, Inc.*, considered before,[57] in that one of three stockholder-officers was bought out by the corporation (in this instance for cash), whereupon the reacquired shares, plus all shares previously unissued, were promptly distributed to the other two executives. Instead of being *pro rata* to their holdings, however, the distribution was deliberately made in such ratio that the two distributees each became owners of 50 per cent of the total authorized capital stock. The corporation sought an expense deduction, but it was held that the evidence sustained the trial court fact finding to the effect that the sole purpose of the distribution was to equalize ownership and, accordingly, was non-compensatory in nature, despite the corporate taxpayer's effort to prove otherwise—hence no allowable deduction.

When transfer to the employee represents a sale, the relation between the consideration received by the corporate transferor and the value of the transferred shares assumes significance for the corporation's tax purposes and poses new problems of fact and law. Although the instances are doubtless too few to give rise to any guiding authority on the point, it is conceivable that an employee's payment in excess of the fair market value of the purchased stock could represent a gift pro tanto to the corporation. More often, of course, the bargain on the transaction is in favor of the employee. Does any determined excess of fair market value of the transferred shares over the amount paid by the employee afford the corporation an expense deduction?

The early Board decision of *Cooperative Furniture Company*[58] answered adversely to the corporation taxpayer: the claimed deduction was summarily disallowed, without opinion. Shortly thereafter an opposite conclusion was reached in *Haskell & Barker Car Co.*,[59] the Board finding that the "spread" favorable to employee-vendees of treasury stock was "intended" as additional compensation, deductible accordingly. A vigorous dissent emphasized, however, that "so far as the corporation was concerned there was simply a change in the personnel of its stockholders," whereby it actually "avoided an expense by giving the employee at an advantageous price an opportunity of sharing in future earnings or liquidation." Slightly later and in accord with *Haskell & Barker Car Co.* were *Commercial Investment Trust Corporation*[60] and *W. M. Ritter Lumber Co.*,[61] applying the rule indiscriminately to corporation sale of both treasury stock and stock theretofore unissued.

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[54] *Alger-Sullivan Lumber Co.* v. *Commissioner* (5 Cir. 1932), 57 F. 2d 3, 10 AFTR 1493, rev'g 20 B.T.A. 1109; *Indianapolis Glove Co.* v. *U.S.* (7 Cir. 1938), 96 F. 2d 816, 21 AFTR 269. (In each of the cited decisions the appellate court held contrary to the Commissioner's contention that the stock distribution was in pursuance of a credit sale made in a prior year; the purported "sales" were denied validity because of the absence of any binding commitment of the employees' general credit—they were found to represent, instead, arrangements whereby blocks of stock were allocated for possible future distribution, to take place when interim credits with respect thereto, measured in the main by current per-share dividend declarations, should aggregate the stipulated "sales" price.)

Note also *Messenger Corporation* v. *Smith* (7 Cir. 1943), 136 F. 2d 172, 31 AFTR 115, holding that a corporate taxpayer sustained a deductible loss in the amount of the value of its shares transferred by it to an *independent contractor* in consideration of services to be (but never) rendered, the transferee defaulting and taking bankruptcy after conversion of the subject of transfer.

[55] *Package Machinery Co.*, 28 B.T.A. 980 (1933)(A).

[56] (D.C. Ct. App. 1932) 57 F. 2d 615, 10 AFTR 1590, cert. den. 287 U.S. 609.

[57] Footnote 34, above.

[58] 2 B.T.A. 165 (1925).

[59] 9 B.T.A. 1087 (1928).

The *Haskell & Barker Car Co.* rule has been strictly confined within its purported limits. It has no application, for instance, to the stock's appreciation in value in the interim between its completed sale to an employee, at a price substantially identical with market value but on credit, and the ultimate delivery of certificate for the pledged shares at the end of the generously arranged pay-out.[62] And where, during the period of pay-out after a sale of such character, dividends applicable to the pledged shares are credited by the corporation to interest accrued on the employee's note, it necessarily follows that the corporation not only is not entitled to any relevant expense deduction but, on the contrary, is taxable on interest income in the amount of such dividends.[63] Qualification of the rule also appears in the well reasoned Board holding of *Electric Storage Battery Co.*[64] In that case the corporation sold to employees in 1929 previously unissued stock, against the stipulated price of which, in supplement of cash payments, were applied salary deductions and accrued "earnings credits" of prior years; the Commissioner argued that no expense deduction was allowable in 1929 at all, the corporation contended for allowance of the excess of the fair market value of the shares over the employees' cash payments, but neither prevailed in full: allowed as a deduction was the amount of the prior years' "earnings credits," which were found to represent compensation for services rendered and to have become first available to the employees in 1929. No significance was attached to the fair market value of the purchased shares. Obviously influenced by the rationale of the *Geeseman* and *Evans* decisions[65] of the preceding year, *Electric Storage Battery Co.* proceeds, without purportedly distinguishing *Haskell & Barker Car Co.*, to assert the modifying proposition that unless there be discernible a manifest and purposeful prearrangement to use the device of a bargain stock sale as a form of compensation, neither taxable income to the purchasing employee nor deductible expense to the selling corporation can be said to result from any incidental excess of the stock's current market value over its selling price.

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[60] 28 B.T.A. 142 (1933), aff'd without opinion (2 Cir. 1935), 74 F. 2d 1015, 15 AFTR 123. But note observations of four dissenting judges: "Other stockholders . . . are the only ones adversely affected by the issuance of additional stock for less than its fair market value. Thereafter they have to be content with a smaller share of corporate distributions. But the income of the issuing corporation certainly is not reduced. Its assets are not reduced."

[61] 30 B.T.A. 231, 274 (1934)(A).

[62] *Gardner-Denver Co.* v. *Commissioner* (7 Cir. 1935), 75 F. 2d 38, 15 AFTR 139, aff'g 27 B.T.A. 1171, cert. den. 295 U.S. 763. Cited approvingly by *Thurman* v. *Studebaker Corporation* (7 Cir. 1937), 88 F. 2d 984, 19 AFTR 235 (which upholds the current tax deductibility of a corporation's periodic credits to employees' accounts designed to facilitate their purchase of shares *at market* from time to time).

[63] *Fairmont Creamery Corporation* v. *Helvering* (D.C. Ct. App. 1937), 89 F. 2d 810, 19 AFTR 601.

[64] 39 B.T.A. 121 (1939)(A). Accord, *Chrysler Corporation*, 42 B.T.A. 795 (1940)(A), involving the sale of treasury stock.

[65] Footnote 53, above.

The criterion of appraisal of the relevant tax consequences would thus seem to be no less the corporate *motive* than the practical *effect* of the transaction. The resulting importance of a clear delineation of purpose in contemporary board of directors resolutions cannot be overemphasized.

In those cases in which the selling corporation be held entitled to an expense deduction in the amount of the employee's underpayment, does not question arise as to the corporation's correct tax accounting treatment of the "spread" between the fair market value of the shares in question and their basis in the corporation's hands? Article 33 of Regulations 62 under the Revenue Act of 1921 provided that "compensation paid an employee of a corporation in its stock is to be treated as if the corporation sold the stock for its market value and paid the employee in cash." Such precise wording has not been carried forward into the corresponding paragraph of Reg. 118, § 39.22 (a)-3, but the sentiment is not imcompatible with the current phraseology. No tax problem emerges if the stock sold to the employee be from that previously unissued: any excess of market value over par would call for no more than a non-taxable credit to capital surplus. But it may well be otherwise if treasury stock be the subject of the transaction. In *Liquid Carbonic Corporation*,[66] where the corporation claimed an expense deduction in the amount of the interim appreciation of its shares between the date of its purchase of same and the date of their application (valued at cost) to satisfaction of the corporation's dollar liability for accrued employee bonuses, the Commissioner urged that any such expense deduction would be equally offset by the gain necessarily realized in the corporation's constructive sale of the shares; the Board purported to find consideration of the argument unnecessary but actually gave indirect effect to it by limiting the corporation's expense deduction to the amount of the accrued dollar liability, just as though it had been met in cash and the employee recipients, as principals, had bought the shares on the open market through their corporate agent. If the Commissioner's argument be accorded validity, a corporation's sale to its employee, with compensatory motive, of a share of its stock for $140 which had been reacquired in the market at a cost of $100 but has now appreciated in value to $175 might well authorize a $35 expense deduction, but it would give rise as a consequence to a $75 revenue credit, a constructive gain. And the matter of taxability vel non of gains realized by the corporation upon sales of its reacquired shares has been sufficiently fruitful of controversy to deserve close examination in the next section of this discussion.

8. Arms-length Sale

Now, as has been noted, special implications arise from a corporation's transfer of treasury stock to those who have been dealt with in the capacity of either stockholder or employee. Independently, however, of such relationship or absence of relationship as the transferee may currently or prospectively bear to the corporation, a tax problem for the corporate transferor inheres in the possible "spread" between the consideration by it received and the determined basis of the transferred shares.

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[66] 34 B.T.A. 1191 (1936). Consider in this connection Senate amendments of recently pending H.R. 6440, apparently designed to preclude any recognition of taxable gain under the circumstances here discussed.

For many years prior to the decision of *Commissioner* v. *S. A. Woods Machine Co.*,[67] the pertinent income tax regulation had provided that "a corporation realizes no gain or loss from the purchase or sale of its own stock." The early Board of Tax Appeals holding in *Simmons & Hammond Manufacturing Co.*,[68] accordingly, denied that any loss could be realized tax-wise on the corporation's sale of treasury shares for less than reacquisition cost, nothing more being involved than rearrangement of stockholder equity in earned surplus. But the *S. A. Woods Machine Co.* case, which, it will be recalled, was concerned with the tax consequences to the corporation incident to *acquisition* of its stock in satisfaction of a claim, exerted a spectacular influence in permanent alteration of the currents of tax law in quite a different channel; from that opinion the Commissioner seized upon a casual illustration to promulgate T. D. 4430, now embodied in Reg. 118, § 39.22 (a)-15,[69] to make the test of taxability of gain or deductibility of loss, upon a corporation's *disposal* of treasury stock, whether or not it may be said to have dealt in its own shares "as it might in the shares of another corporation." Thus was opened a Pandora's box of litigation.

The Treasury assault was directed initially upon transactions that antedated promulgation of T. D. 4430. It came to naught in the Second Circuit, Judge L. Hand, in *E. R. Squibb & Sons* v. *Helvering*,[70] not only holding that the 1934 ruling could not be applied retroactively, but also venturing the belief that nothing less than appropriate Congressional action would be required to effect prospectively the profound change of long established law that T. D. 4430 undertook to accomplish; moreover, only to the extent that the sale price of the treasury shares exceeded, *not* basis, but current fair value could the corporation be said to reap any profit in any true economic sense.

Meanwhile the Commissioner had been similarly rebuffed in the Fourth Circuit in the *R. J. Reynolds Tobacco Co.* case,[71] but had carried his point in the Third Circuit in that of *First Chrold Corporation*,[72] both relating to pre-1934 corporation sales of treasury stock. To resolve the conflict the Supreme Court granted a writ. Briefly reversing the *First Chrold Corporation* decision, the Court affirmed *Helvering* v. *R. J. Reynolds Tobacco Co.*[73] in a carefully reasoned opinion which denied retroactive application of the 1934 amendment of the regulations but expressly pretermitted determination of the secondary issues raised in *E. R. Squibb & Sons.* As a consequence, ensuing taxpayer-Commissioner controversies as to taxability vel non to a corporation of the excess of consideration received upon the sale of treasury stock over the basis thereof called for resolution of the two-fold question: whether the 1934 promulgation effectually superseded prior law, without the necessity of Congressional implementation, and, if so, whether in each instance the transaction evidenced such a character of "dealing" in the dealer's own stock as the amended regulation contemplated.

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[67] Footnotes 23 and 24, above.

[68] 1 B.T.A. 803 (1925). Accord in principle, *Farmers Deposit National Bank,* 5 B.T.A. 520 (1926), and Interurban Construction Co., 5 B.T.A. 529 (1926).

[69] Footnote 27, above. The later (1936) G.C.M. 16651, C.B. XV.-2 130, rules specifically that a corporation's gain on the sale of treasury stock to employees pursuant to an established stock purchase plan is to be recognized for tax purposes.

[70] (2 Cir. 1938) 98 F. 2d 69, 21 AFTR 654, rev'g 36 B.T.A. 260.

[71] (4 Cir. 1938) 97 F. 2d 302, 21 AFTR 367. Accord, *National Home Owners Service Corporation*, 39 B.T.A. 753 (1939) (NA).

[72] (3 Cir. 1938) 97 F. 2d 22, 21 AFTR 308.

[73] 306 U.S. 110, 117, 22 AFTR 272, 276 (1939).

A formidable series of appellate court holdings proceeded with unbroken uniformity, but not without impressive dissents, to dispose of all doubts in the Commissioner's favor.[74] A compact attempted definition of the area of dispute as to the meaning of the now judicially validated regulation appears in the *Air Reduction Co.* opinion; the consistently unsuccessful corporate taxpayer, says Judge Chase, usually

> contends that the regulation applies only to such active trading in the company's own stock as would normally be done for speculative purposes. But this, we think, is too narrow an interpretation. The regulation contemplates rather such dealing in one's own stock as exists whenever that treasury stock is employed as an ordinary asset as the stock of another corporation would be. Thus capital readjustments would be outside the scope of the regulation, but not a transaction where the treasury stock is dealt with as a normal asset of the corporation.

In the later *Aviation Capital, Inc.* case, Judge Frank, reluctantly concurring in deference to stare decisis, takes occasion nevertheless to pay tribute to Judge Hand's opinion in the *E. R. Squibb & Sons* case and his dissent in the *Air Reduction Co.* case and to bemoan that "the prevailing rule is a singular triumph of form over substance."

The "rule," however, has been considerably less prevailing in the Tax Court. In accord with the consistent Courts of Appeals conclusions, it is true, was the Board holding in *Pittsburg Laundry Co.*;[75] and the memo decision of *D. N. & E. Walter & Co.*[76] also went along, somewhat to the Commissioner's chagrin, to allow a deductible loss incurred upon the corporation's sale of treasury stock to employees. But the ensuing decisions of *Dr. Pepper Bottling Co. of Mississippi*,[77] *Brockman Oil Well Cementing Co.*,[78] and *Cluett, Peabody & Co.*[79] each denied applicability of the regulation under circumstances of sale of treasury stock which may well have been expected to receive an entirely different construction on appeal. Singularly enough, all were acquiesced, notwithstanding Opper's dissent in *Cluett, Peabody & Co.* on the ground of its square conflict with the definite line of authority in five circuits.

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[74] *Commissioner* v. *Air Reduction Co.* (2 Cir. 1945), 130 F. 2d 145, 29 AFTR 1078, cert. den. 317 U.S. 681; *Aviation Capital, Inc.* v. *Pedrick* (2 Cir. 1945), 148 F. 2d 165, 33 AFTR 899, cert. den. 326 U.S. 723; *Allen* v. *National Manufacture & Stores Corporation* (5 Cir. 1942), 125 F. 2d 239, 28 AFTR 1020, cert. den. 316 U.S. 679; *Dow Chemical Co.* v. *Kavanagh* (6 Cir. 1943), 139 F. 2d 42, 31 AFTR 982; *Helvering* v. *Edison Bros. Stores* (8 Cir. 1943), 133 F. 2d 575, 30 AFTR 940, cert. den. 319 U.S. 752; *Brown Shoe Co.* v. *Commissioner* (8 Cir. 1943), 133 F. 2d 582, 30 AFTR 947; *U.S.* v. *Stern Bros. & Co.* (8 Cir. 1943), 136 F. 2d 488, 31 AFTR 191. Accord, *Investment Corporation of Philadelphia* v. *U.S.* (D.C., E.D. Pa. 1941), 43 F. Supp. 64, 28 AFTR 1217; *Edwin L. Wiegand Co.* v. *U.S.* (Ct. Cls. 1945), 60 F. Supp. 464, 33 AFTR 1339.

[75] 47 B.T.A. 230 (1942). Accord, A. R. *Purdy & Co., Inc.*, 3 T.C.M. 1059, Memo Docket No. 2763, par. 44,329 Prentice-Hall Memorandum T.C. (1944), where corporation debt was discharged by transfer of treasury shares with an aggregate basis less than the amount of the debt.

[76] B.T.A. Memo. Docket No. 107930, par. 42,378 Prentice-Hall Memorandum B.T.A. (1942).

[77] 1 T.C. 80 (1942)(A).

[78] 2 T.C. 168 (1943)(A).

[79] 3 T.C. 169 (1944)(A). But see *M. Conley Company*, 6 T.C. 250 (1946), conforming to the Courts of Appeals line of authority; Opper, concurring, professes to see no distinguishing feature between the facts of the instant case and those of the prior *Cluett, Peabody & Co.*

The Tax Court's approach to the problem in the cited decisions is illustrated by the *Dr. Pepper Bottling Co.* opinion's summary of the governing propositions held to have been established by prior relevant decisions:

> first, that whether a corporation's dealings in its own stock result in tax consequences to the corporation, depends upon the character and purpose of the purchase and of the sale and their relationship to each other; second, that if their true nature is a readjustment of capital, no taxable gain or loss occurs even though the result is more than a mere bookkeeping process and the outcome may in a real sense be a benefit or detriment to the corporation's economic position; and, third, that one test of the true nature of the transaction is whether the corporation has dealt in its stock in the same way that it would in the stock of another corporation.

The divergent viewpoints of the Tax Court and the Courts of Appeals, which, in this writer's opinion, simply defy any effort to achieve a case-by-case factual reconcilement, manifest sharply contrasting interpretations of that troublesome little clause, "deals in its own shares as it might in the shares of another corporation." The Tax Court inclines to accept it as though it might read "pursues a policy of speculation or investment in its own shares, inspired by no other motives than would impel a similar course of dealing in other equities," definitely inapplicable, therefore, to situations where the controverted transaction is primarily directed toward readjustment of capital structure; the Courts of Appeals. on the contrary, favor a construction which might be said to cast the regulatory provision in the words "sells as much as a single share of its treasury stock, howsoever or with whatsoever motive acquired, in the same manner in which it would dispose of any other equity." The Courts of Appeals find it increasingly difficult, therefore, to conceive of any treasury stock sale to which the regulation does not apply. In fairly rapid succession in later years four climactic decisions, each reversing the Tax Court's holding on the point, have brought the Second Circuit,[80] the Seventh Circuit,[81] the Third Circuit,[82] and the Sixth Circuit[83] in square accord and discouraged hope of a writ of certiorari.

The opinion in the cited *Porter & Co.* case from the Third Circuit emphasizes the immateriality of corporate *motive* in original reacquisition and subsequent disposal:

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[80] *Commissioner* v. *Batten, Barton, Durstine & Osborn, Inc.* (2 Cir. 1948), 171 F. 2d 474, 37 AFTR 661, rev'g 9 T.C. 448, cert. den. 338 U.S. 816.

[81] *Commissioner* v. *Rollins Burdick Hunter Co.* (7 Cir. 1949), 174 F. 2d 698, 37 AFTR 1503, rev'g 9 T.C. 169.

[82] *Commissioner* v. *H. W. Porter & Co.* (3 Cir. 1951), 187 F. 2d 939, 40 AFTR 339, rev'g 14 T.C. 307.

[83] *Commissioner* v. *Landers Corp.* (6 Cir. 1954), 210 F. 2d 188, which reversed the T.C. Memo. Docket No. 31189, par. 52,172 Prentice-Hall Memorandum T.C. (1952); the absence of profit motive in original purchase plus the inducing need of additional capital in later sale had been emphasized by the Tax Court, undismayed by repeated reversals, to support its conclusion that the shares had not been dealt in as would be those of another corporation. Even where an opposite conclusion on the facts was reached in *Juvenile Shoe Corporation of America*, 17 T.C. 1186 (1952), it was remarked that "We need express no opinion as to our present willingness to accede to the views of the respective appellate courts in" B. B. D. & O., R. B. H. Co., and *H. W. Porter & Co.*

The Commissioner takes the position that whenever a corporation reacquires its own shares, for the purpose of reselling them, holds them in its treasury instead of retiring them and later does sell them, it is dealing in its shares as in the shares of another and thus comes within the Regulation. He says that so long as there is no readjustment in capital structure the economic gain or loss to the corporation is the same regardless of the motive of the corporation in dealing in its own stock.

We agree with the Commissioner. Once it is accepted that there is gain or loss tax-wise when a corporation buys and resells its own stock without retiring it, there appears no basis for any inquiry into motive. The existing cases on the subject all point to this result, save those decided by the Tax Court.

One is still left to ponder what character or degree of "readjustment in capital structure" suffices to remove the transaction from the scope of application of the § 39.22 (a)-15. Such a qualifying readjustment has been frequently discernible to the Tax Court in a given set of facts, but rarely, if ever, to the Courts of Appeals.

Fifteen days after the recent Sixth Circuit decision of the *Landers Corp.* case the Tax Court hued unrepentantly to its former line of authority, holding in *Timken-Detroit Axle Company,*[84] without allusion to *Landers Corp.* but "with due deference to" the views expressed in the three earlier Courts of Appeals decisions, that no taxable gain was realized by the corporation upon its sale of treasury stock, for an amount in excess of cost, to an executive who warranted that the purchase was "for investment and not for resale." But five months later the Tax Court majority (five judges dissenting) finally bowed in *Burrus Mills, Inc.*[85] to the overpowering weight of appellate court authority and unequivocally abandoned the position so resolutely maintained through *Timken-Detroit Axle Company.*

Almost simultaneously with the Tax Court's retreat, however, a new judicial champion for the beleaguered corporate taxpayer rushed into the breach. In its recent decision of *Anderson, Clayton & Co.* v. *U.S.*[86] the Court of Claims took square issue with the successive Courts of Appeals holdings on the point under examination, remarking, inter alia, that their "distinction between treasury stock and unissued stock is one of form," rather than logical substance. "The question that confronts the court in these cases," the opinion observes , . . . "is whether the treasury stock was treated in substance as an asset rather than stock of the corporation," i.e., a capital-raising potential. Refusing to discern taxable gain in the corporation's "incentive" sales to junior executives, at a formula-determined figure, of shares previously acquired from the estate of a deceased stockholder, the Court climaxed a careful historical and accounting analysis of the subject of controversy by rejection of the Courts of Appeals views and unqualified adoption of the previous Tax Court line of authority:

> We agree with the Tax Court's position because: (1) we entertain some doubt as to whether a corporation's purchasing and selling its own stock is not really a capital transaction, (2) the basis for the Circuit Courts' decisions is one of form only in that it rests entirely on the failure of the corporation to go through the formal mechanics of actually retiring the stock and issuing new stock, and (3) the plain terms of the regulation support the Tax Court's position.

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[84] 21 T.C. 769 (2-26-54), non-acquiesced I.R.B. No. 38, Sept. 20, 1954 at page 5.

[85] 22 T.C. 881 (7-14-54). Note that this case arose in the Fifth Circuit, the Court of Appeals for which does not appear to have spoken on the point at issue since 1942—see Footnote 74, above.

[86] (Ct. Cls. 7-13-54) 122 F. Supp. 837, Prentice-Hall Current Court Decisions par. 72,680, cert. granted, 2/7/55.

Finally, Congress has now made a significant contribution toward clearing up this area of protracted judicial discord. "To remove the uncertainties of present law," according to the Senate Finance Committee's Detailed Discussion, Section 1032 of the recently enacted 1954 Code provides that "No gain or (sic) loss shall be *recognized* to a corporation on the receipt of money or other property in exchange for stock (*including treasury stock*) of such corporation." (Italics supplied). For years to which the new Code be applicable, therefore, a corporation disposing of treasury stock for an amount deviating from the tax basis thereof should not, as heretofore, have to make the adverse assumption that current taxability of any favorable "spread" will be asserted, yet allow no less for possible Government challenge of deductibility of loss in a converse situation; thanks to Congress, in short, a sale of treasury stock is no longer the harbinger of immediate tax dispute.

It may well be questioned, however, whether Section 1032 has vouchsafed to the corporate taxpayer more than temporary postponement of possible controversy. The language appears to have been carefully chosen, studiously avoiding any implication of *exclusion* from taxability; it is susceptible of construction to the effect that such gain or loss as may be determined under other Code provisions and applicable regulations to have been realized by a corporation from sale or exchange of its own shares shall merely be denied current recognition. What becomes accounting-wise, and ultimately tax-wise, of the non-recognized currently realized gain (or loss)? Do we have a permanently non-taxable (or non-deductible) surplus entry, credit or charge as the case may be, in line with the apparent assumption of many first-blush comments on the new Code? Or, in the absence of a basis-substitution situation, is some character of general basis adjustment indicated, laying the predicate for tax repercussions in later years? The cross-reference in Section 1032(b) throws but limited light on the matter. It will be interesting to see what future regulations may do with this statutory forward step.

No pat generalization is warranted by the foregoing review. Nevertheless, all phases of the subject considered, one conclusion is inescapable: the tax hazards attendant on treasury stock transactions are such that both caution in acquisition and permanent retirement thereafter represent the policy of corporate dealing which promises a minimum of vexatious litigation.[87] A strong judicial trend in favor of classification of treasury stock as a form of investment asset, rather than simply a capital potential indistinguishable tax-wise from shares authorized but unissued, has been lately evident, certainly among the appellate courts;[88] the exceptions that do recurrently appear have been, for the most part, at the behest and for the benefit of the taxgatherer, notably in gauging the tax liability of the stockholder who sells a portion of his shares to the corporation.[89] Worthy of heed is the admonition of a discerning commentator that the stock certificate book be prominently labeled with the warning "Watch out for treasury stock!" [90]

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[87] At least one investment trust whose shares are widely held is known to have besought stockholder authorization to reduce capital by retirement of stock presently held in the treasury and immediately thereafter "to make a corresponding increase in the capital stock," so as to provide additional shares available for issue without threat of tax detriment.

[88] Note relevant comment in both the majority and dissenting opinions of *Firestone Tire & Rubber Co.*, 2 T.C. 827 (1943) (NA), app. dism'd (6 Cir. 1944).

[89] See "Distributions in Redemption of Stock," page 822.

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[90] John Westbrook Fager, 27 *Taxes* 719, 725, August 1949.

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Paying Dividends

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Taxwise, a dividend is usually something to be avoided. From the point of view of the corporation it is a non-deductible disbursement. To the individual shareholder it is ordinary income after the first $50.[1] Although the individual's tax is reduced by 4 per cent of the taxable dividend,[2] it gives the Government a second and substantial bite of earnings already subjected to the corporate tax. This chapter is intended as a guide to the dividend problem. You must in the first place be able to recognize a dividend or potential dividend when you see one. Once you have spotted a dividend, or decided to pay one, you must know what the tax consequences are likely to be both to the corporation and to the shareholders. We are not here concerned with the question of whether a dividend should be paid. (See Chapters on Sec. 102 and on Personal Holding Companies).

1. Points to Consider

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[1] Effective for tax years ending after July 31, 1954 the first $50 of dividends received by an individual in his tax year is excluded from his income. On a joint return, the exclusion is $100 if husband and wife each received dividends of $50 or more. 1954 IRC § 116.

[2] Effective as to dividends received after July 31, 1954 an individual is entitled to a credit against his tax of 4 per cent of such dividends, but not exceeding 2 per cent of taxable income for years ending before 1955 and 4 per cent of taxable income for later years. 1954 IRC § 34. Dividends excluded under the $50 exclusion do not enter into the computation of the credit. Both the dividend exclusion and the credit do not apply to dividends from tax exempt corporations or cooperatives, foreign corporations, certain insurance companies, mutual savings banks, cooperative banks and building and loan associations.

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What is the effect of selling the stock in determining to whom a dividend is taxable? 9
Can a dividend be unscrambled? 10

2. The Unintended Dividend

Where a corporation has accumulated or current earnings (See Sections 3 and 4), every transaction in which a stockholder derives an economic benefit directly or indirectly related to the corporation must be scrutinized in order to determine whether the transaction may be held to result in a taxable dividend in whole or in part. The benefit may constitute a dividend notwithstanding that the formalities of a dividend declaration are not observed, that the benefit is cast in another form and is not recorded on the corporate books as a dividend, that the benefit is not in proportion to stock ownership or even that some stockholders do not participate. Basic to all unintended dividend cases is the determination that the substance of the transaction has the effect of a distribution of profits to the stockholder.[3]

Examples of normally deductible items which may eventually be viewed as dividends:

1. Excessive compensation to shareholder-officers.[4]
2. Excessive rent to shareholder-lessors.[5]
3. Excessive royalties to shareholder-licensors.[6]
4. "Interest" on "debt" securities which are held to be stock.[7]

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[3] For a discussion of unintended dividends, see Leo A. Diamond, "Dividend Payments of a Small Closed Corporation," *Taxes*, July 1951, Vol. 29, page 617; John W. Drye, Jr., "Earned Surplus and Its Tax Problems for the Stockholder," *Tax Law Review*, May 1949, Vol. 4, page 421.

[4] Reg. 118, § 39.23(a)-7. This is probably the commonest type of unintended dividend. Where a close corporation is involved payments made to stockholder-officers as compensation for services will be carefully scrutinized to determine whether they in fact constitute a distribution of profits. See *University Chevrolet Co. Inc.* 16 T.C. 1452 (1951), affirmed (5 Cir. 1952) 199 F. 2d 629.

[5] Where rent is paid as the result of an arm's-length transaction the Code does not limit the deduction for rental to a reasonable amount. But where there is evidence that some part of the alleged rent payments in fact constitute dividends or gifts, the allowable deduction for rent has been limited to an amount determined to be "required" for the continued use or possession of the property by the lessee. *Manos Amusements, Inc.*, 10 T.C.M. 748 (1951), affirmed (6 Cir. 1953) 202 F. 2d 152; *Floridan Hotel Operators, Inc.*, 12 T.C.M. 136 (1953); *Limericks, Inc.*, 7 T.C. 1129 (1946), affirmed (5 Cir. 1948) 165 F. 2d 483, 36 AFTR 649; *Catherine Armston*, 12 T.C. 539 (1949); *Commissioner* v. *Greenspun* (5 Cir. 1946), 156 F. 2d 917, 35 AFTR 48, on remand Prentice-Hall Federal Tax Service, par. 48,135.

[6] *Granberg Equipment Co.*, 11 T.C. 704 (1948); *Ingle Coal Corp.*, 10 T.C. 1199 (1948), affirmed (7 Cir. 1949) 174 F. 2d 569, 37 AFTR 1485. *Bona fide* royalty payments to stockholders are, of course, deductible. See *Nelson* v. *Commissioner* (6 Cir. 1953), 203 F. 2d 1, reversing 11 T.C.M. 21 (1952). Even where an employee-developed patent is distributed by the corporation to its stockholders as a dividend in kind and the stockholders subsequently enter into a license agreement with the corporation, the royalty payments for the use of the patent may be deducted by the corporation as business expenses if the license agreement is reasonable. *Stearns Magnetic Manufacturing Company* v. *Commissioner* (7 Cir. 1954), 208 F. 2d 849, reversing 11 T.C.M. 535 (1952).

[7] An interest deduction is likely to be challenged where certificates of indebtedness are issued in exchange for stock and where there is a variable interest rate dependent upon corporate earnings. *Kelley Co.* v. *Commissioner*, 326 U.S. 521, 34 AFTR 314 (1946). Compare *Bemis Hardwood Lumber Co.* v. *U.S.* (D.C., W.D. No. Car. 1954), 117 F. Supp. 851. The ratio of debt

Result: Disallowance of the corporation's deduction to the extent that the payment is held to be a dividend.

Examples of capital transactions involving potential dividends:

1. Purchase of property from shareholders at an excessive price.[8]
2. Bargain sales of corporate property to stockholders.[9]
3. "Loans" to shareholders which are not intended to be repaid.[10]
4. Stock redemptions subject to 1954 IRC § 302 (d), 1939 IRC § 115 (g).[11]
5. Boot payments in reorganizations subject to 1954 IRC § 356 (a) (2), 1939 IRC § 112 (c) (2).[12]
6. Spin-off distributions used as a device to distribute earnings and profits and therefore not within the saving provisions of 1954 IRC § 355 (a) (1) (B), 1939 IRC § 112 (b) (11).[13]

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to equity investment may be significant in this connection. *Swoby Corp.*, 9 T.C. 887 (1947); See *Sam Schnitzer*, 13 T.C. 43 (1949). Of course a corporation may enter into a debtor and creditor relationship with its stockholders. *Wilshire and Western Sandwiches, Inc.* v. *Commissioner* (9 Cir. 1949), 175 F. 2d 718, 38 AFTR 116. But the distribution of debentures by a corporation as a dividend to its wholly owned subsidiary did not create a valid debtor-creditor relationship. *Kraft Foods Co.*, 21 T.C. No. 63 (1954). A "thin" incorporation, i.e. the formation of a corporation with a maximum of debt and a minimum of capital, may be sufficient reason for disallowance of interest deductions on the debt. See *dicta* in *Kelley Co.* v. *Commissioner*, *supra*. Furthermore, repayment of the principal of the "debt" may be held to be a taxable dividend. *R. E. Nelson*, 19 T.C. 575 (1952). There is no precise guide to the extent of permissible "thinness." But the Commissioner has acquiesced in *Ruspyn Corp.*, 18 T.C. 769 (1952) where the interest deduction was allowed and the ratio of debt to capital was 3½ to 1. The Tax Court has also allowed the interest deduction where the debt-capital ratio was as high as 9 to 1. *Bacon, Inc.*, 4 T.C. 1107 (1945). Where the corporate financial structure is overbalanced by indebtedness after incorporation for business reasons not foreseeable at the formation of the corporation, the courts are likely to find that no tax avoidance motive existed. *Earle* v. *W. J. Jones & Son, Inc.* (9 Cir. 1952), 200 F. 2d 846.

[8] This position was taken by the Commissioner in *George J. Staab*, 20 T.C. No. 119 (1953) (acq.) but he was unsuccessful because the additional price paid by the corporation was properly attributable to good-will. See *Albert E. Crabtree, et al.*, 22 T.C. No. 9 (1954) where the excessive consideration took the form of an anticipatory arrangement for the distribution of dividends in the future.

[9] A corporation may permit its stockholders to purchase corporate property, for example, stock of another corporation, at less than fair value. Subject of course to the earnings and profits requirement, the excess value over and above the price paid is a taxable dividend. Here again the problem is one of valuation. In a closely held corporation it is always a temptation to make the sale at book value with no gain or loss to the corporation. But "book" may be considerably under fair value and the result may be disastrous if value is uncertain, for example, where a going business having a substantial good-will value is sold to the shareholders at book value. See Chapter on "Bargain Sales to Stockholders."

[10] Whether or not withdrawals of corporate funds by a stockholder constitute loans or dividends is a question of fact. See the charge to the jury in *Adams* v. *Glenn* (D.C. W.D. Ky. 1950) 50-2 USTC par. 9447. Absence of notes, failure to pay interest, lack of a written agreement or other evidences of an intention not to repay loans together with corporate control by borrowers are essential factors in establishing dividends. *Regensburg* v. *Commissioner* (2 Cir. 1944), 144 F. 2d 41, 32 AFTR 1141, cert. den. 323 U.S. 783 (1944); *W. T. Wilson*, 10 T.C. 251 (1948). But see *Carl L. White*, 17 T.C. 1562 (1952) where the borrower's withdrawals were not taxed as dividends because he owned only 40 per cent of the stock and there was no understanding among all the stockholders authorizing the excessive withdrawals. In any event taxable dividends will almost always result from a cancellation of the indebtedness arising from withdrawals.

[11] See Leon Gold "Common Method of Selling Close Corporation Hit by District Court," *American Bar Association Journal*, November 1952, Vol. 38, page 955; but see *Zeuz* v. *Quinlivan*, (6 Cir. 1954), 213 F. 2d 914.

[12] See Chapter on "Corporate Distributions."

[13] See Chapter on "Dividing a Business."

Result: Corporation's tax is unaffected, but that which the shareholder assumed to be capital or capital gain is taxable as ordinary income.

Other unusual transactions which may give rise to unexpected dividend income are:

1. Purchase of life insurance for shareholder's benefit.[14]
2. Permitting a shareholder to use or occupy corporate property rent-free, or for an inadequate rental.[15]
3. Discharge of shareholder's obligations or payment of personal expenses.[16]
4. Diversion of corporate income to shareholder.[17]
5. Purchase by corporation of stock of another shareholder at a price which reflects future earnings.[18]

3. Earnings and Profits

A dividend is a distribution of the corporation's "earnings or profits" accumulated since February 28, 1913, or "earnings or profits" of the taxable year.[19] All other corporate distributions to stockholders represent a non-taxable return of capital or capital gain.[20] There are really two accounts: (1) earnings of the current year computed as of the close of such year, and (2) earnings accumulated after February 28, 1913. If the current year's earnings after taxes are sufficient to cover the distribution, you need look no further[21]—you have a taxable dividend even though current earnings are more than offset by accumulated prior years' deficits. On the other hand, if the distribution exceeds current earnings, you must then determine whether the excess is covered by the company's accumulated earnings on hand at the close of the preceding year.

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[14] Where the insurance was not a benefit to the corporation but only to its stockholders under their contract for the purchase and sale of its stock—*Paramount-Richards Theatres, Inc.* v. *Commissioner* (5 Cir. 1946), 153 F. 2d 602, 34 AFTR 931. See Mannheimer and Friedman, "Stock Retirement Agreements," *Taxes*, May 1950, Vol. 28, page 423.

[15] This possibility, that such rent-free use may give rise to dividend income, should be taken into account in connection with the incorporation of the taxpayer's residence or summer home. On the other hand, if rent is paid, the effect is to create taxable income, which would not have existed at all if the title had not been transferred; and, to make matters worse, this may turn out to be personal holding company income under 1954 IRC § 543(a)(6); 1939 IRC § 502(f) if the corporation has other personal holding company income amounting to more than 10 per cent of its total gross income. The rental value may be treated as compensation in lieu of dividends. *Paulina Dean*, 9 T.C. 256 (1947); *J. Simpson Dean*, 9 T.C.M. 260 (1950), affirmed (3 Cir. 1951) 187 F. 2d 1019.

[16] *Wall* v. *U.S.* (4 Cir. 1947), 164 F. 2d 462, 36 AFTR 423. But see *Paulina Dean*, 9 T.C. 256 (1947).

[17] *Currier* v. *U.S.* (1 Cir. 1948), 166 F. 2d 346, 36 AFTR 775; But see *Lucille Rogers*, 11 T.C. 435 (1948); reversed on this point (3 Cir. 1950) 180 F. 2d 720; contra on same facts *American Range Lines Inc.* v. *Commissioner*, 17 T.C. 764 (1951); modified and remanded (2 Cir. 1952) 200 F. 2d 844.

[18] This possibility has been suggested informally by certain Internal Revenue Service officials. The theory is that corporate earnings have been used for the benefit of the remaining shareholders to acquire for them a larger share of future earnings. This seems at least questionable. The remaining shareholders actually end up with a lowered per share book value; any benefits moving to them are highly conjectural. The situation in which the corporation is discharging the remaining shareholder's obligation to purchase the stock should be distinguished. See *Wall* v. *U.S.* (4 Cir. 1947), 164 F. 2d 462, 36 AFTR 423; *Fred F. Fischer*, par. 47,131 Prentice-Hall Memorandum T.C. (1947). Compare also the situation where a stockholder sells part of his stock to a purchaser and thereafter has the balance of his stock redeemed by the corporation, *Zeuz* v. *Quinlivan*, (6 Cir. 1954) 213 F. 2d 914; Rev. Rul. 54-458, IRB 1954-42, 15.

[19] 1954 IRC § 316(a); 1939 IRC § 115(a).

[20] 1954 IRC § 301(c); 1939 IRC § 115(d). See 1954 IRC § 301(f) for cross reference to special rules.

[21] Reg. 118, § 39.115(a)-1; *William C. Maguire*, 21 T.C. No. 98 (1954).

Every distribution to shareholders is conclusively presumed to have been made from earnings to the extent thereof and from those earnings most recently accumulated,[22] starting with the earnings of the taxable year. Short of a redemption or liquidation treated as an exchange for stock, a corporation may not make a distribution from a nontaxable source (for example, capital, paid-in surplus, pre-1913 earnings) until it has exhausted its current and post-1913 accumulated earnings.

Other rules governing the application of earnings to corporate distributions are:

1. The current year's earnings are first applied pro rata against all distributions during the year, regardless of the amounts on hand at the date of each distribution.[23]

2. Accumulated earnings of prior years are then applied to the balance of each distribution in the order of time.

Example: (from Reg. 118, Section 39.115 (b)-1)

Accumulated earnings Jan. 1, 1952	$12,000
Earnings during 1952	30,000
Distributions during 1952 (four quarterly distributions of $15,000 each)	

The result in tabular form:

	DISTRIBUTIONS	PAID OUT OF 1952 EARNINGS	PAID OUT OF PRIOR ACCUMULATED EARNINGS	AMOUNT TAXABLE
March	15,000	7,500	7,500	15,000
June	15,000	7,500	4,500	12,000
September	15,000	7,500		7,500
December	15,000	7,500		7,500

If the corporation had started the year with a $100,000 deficit, $7,500 of each distribution would still be taxable, even though the 1952 earnings did not wipe out the deficit.

3. Post-1913 losses are first applied to wipe out earnings of prior years, including *pre-1913 earnings,* and only after such earnings have been exhausted, to offset earnings of subsequent years.[24]

4. How to Calculate Earnings and Profits for Tax Purposes

No attempt will be made to cover all the refinements of this highly complex subject.[25] In practice it is important merely to understand the nature of the earnings and profits account and its relation to the corporation's taxable net income. To determine the amount of current earnings available for the payment of taxable dividends in each year: start with the year's taxable net income, then make the following adjustments:

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[22] 1954 IRC § 316(a); 1939 IRC § 115(b).

[23] Where distributions are made on both preferred and common stock, the earnings are first applied against the preferred distribution. G.C.M. 21122, 1939-1 C.B. 187.

[24] *Helvering* v. *Canfield,* 291 U.S. 163, 13 AFTR 857 (1934); Reg. 118, § 39.115(a)-2. See Charles W. Tye, "Corporate Distributions—Some Current Trends," *Tax Law Review,* May 1949, Vol. 4, page 459. The reverse situation, however, is not true—post-1913 earnings are not applied to restore pre-1913 losses in determining amount of profits available for dividends for tax purposes. *Commissioner* v. *Kelham* (9 Cir. 1951), 192 F. 2d 785, reversing 13 T.C. 984 (1949), cert. den. 72 S.Ct. 760.

[25] See W. G. Austin, "Corporate Earnings and Profits Under the Internal Revenue Code," *Baylor Law Review,* Winter 1952, Vol. 4, page 129; Arthur R. Albrecht, " 'Dividends' and 'Earnings or Profits,' " *Tax Law Review,* January 1952, Vol. 7, page 157; John G. Jaeger, "Earnings and Profits in Federal Income Taxation," *The Controller,* February 1952, Vol. XX, page 62.

1. Deduct federal income and excess profits taxes paid or accrued.
2. Deduct any net capital loss.
3. Add back 85 per cent of any dividend received from other corporations.[26]
4. Add back net operating losses carried forward or back from other years.[27]

These are the major adjustments, the ones most likely to be applicable. In addition, certain other adjustments[28] are sometimes required to reflect the receipt of income items that are not taxable, or the disbursement of current expense or other items which are not deductible. For example:

5. Add exempt interest, for instance that received on municipal bonds.[29]
6. Add life insurance proceeds received at death of insured.
7. Deduct premiums on life insurance carried on officer or employee.
8. Deduct charitable contributions in excess of the amount allowed as a deduction.
9. Deduct special assessments that are not deductible as taxes.
10. Add back excess of percentage depletion over cost depletion. (This excess does not reduce earnings although it is allowed as a deduction to corporations engaged in mining or the oil business.)[30]
11. Add corporate indebtedness to stockholder, the collection of which is barred by the statute of limitations.[31]

The resulting sum is the primary source of taxable dividends. It is intended to represent the corporation's current net earnings (including those which are exempt from tax) after all proper charges (including those that are nondeductible) have been paid or accrued.

Finally: to determine the amount of the current earnings remaining undistributed at the close of the year deduct the amount of dividends paid to shareholders during the year, if paid in cash deduct the amount of money, if paid in obligations of the corporation deduct the principal amount of the obligations, if paid in other property (except certain inventory assets) deduct the adjusted basis of such property.[32]

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[26] In case of a dividend in kind received by a corporation after August 31, 1950, the credit is limited to 85 per cent of the adjusted basis of the property in the hands of the distributing corporation. 1939 IRC § 26(b) as amended by the Revenue Act of 1950. Under 1954 IRC §§ 243(a) and 301(b)(1)(B) both the dividend income and the credit are limited to the adjusted basis of such property thereby removing an inequity that existed under the 1939 Code.

[27] Such losses are of course taken into account in the year in which they occurred.

[28] Most of the adjustments mentioned appear in the schedule on the corporate return (Form 1120), titled "Reconciliation of Taxable Income and Analysis of Earned Surplus and Undivided Profits."

[29] Reg. 118, § 39.115(a)-2(b). Amortizable bond premium on wholly tax-exempt bonds, although not deductible in computing taxable net income, must be taken into account in the computation of earnings and profits. I.T. 3764, 1945 Cum. Bull. 188.

[30] Reg. 118 § 39.115(a)-2(c)(1).

[31] *Schweppe* v. *Commissioner* (9 Cir. 1948), 168 F. 2d 284, affirming 8 T.C. 1224 (1947).

[32] 1954 IRC § 312(a). See *Commissioner* v. *Goldwyn* (9 Cir. 1949), 175 F. 2d 641, holding that the mere declaration of a dividend reduced earnings even though the dividend was not paid or taxable to shareholders until a later year.

If inventory assets (as defined in the statute)[33] having a fair market value in excess of adjusted basis are distributed as dividends, the earnings and profits account is first increased by such excess and then decreased by the lesser of the fair market value of the inventory assets distributed or the earnings and profits as so increased.[34]

The balance becomes a part of the company's accumulated earnings as of the close of the year, available for the payment of taxable dividends in succeeding years. If the year's distributions exceed the current earnings, the excess will be chargeable to accumulated earnings as of the beginning of the year, and the amount to be carried forward into the next succeeding year will be reduced accordingly.

Some further refinements: Only taxable dividends to shareholders are chargeable to earnings. Distributions from capital, capital surplus, valuation write-ups, pre-1913 earnings, or other nontaxable sources, or in the form of nontaxable stock dividends, do not affect the earnings and profits account.[35]

The corporation's gains and losses are taken into the account only to the extent that they are *recognized.*[36] Mere bookkeeping write-ups and write-downs in values are of course disregarded. Unrecognized gains and losses include those realized in reorganization exchanges and involuntary conversions. They also include disallowed wash sale losses. The corporation's basis carries over to the new property acquired in such transactions and exchanges. The result is merely to postpone the gain or loss until the new property is finally disposed of. At that time the gain or loss will be reflected in the earnings account. This rule does not extend to losses disallowed under Section 24(b)—sales to controlling shareholders.[37] Such losses are chargeable to earnings, even though they do not reduce the corporation's taxable income.

Where the corporation has acquired property from its shareholders in a nontaxable exchange and, for tax purposes, holds the property at the shareholders' basis, this same "substituted basis" must be used on sale of the property in calculating the gain or loss to be taken into the earnings and profits account.[38]

Example: Corporation X receives from its shareholders at organization 1,000 shares of Y stock. The Y stock cost the shareholders $1,000 but was worth $10,000 when it was received by X. If X later sells the stock for $15,000 its gain is $14,000, since its basis is $1,000 for all tax purposes, including the calculation of earnings and profits.

One corporation may inherit earnings and profits from another when it acquires the latter's property in a nontaxable exchange.[39]

Examples: (1) In a reorganization, Corporation A is organized to take over all the assets of Corporation B in exchange for A's stock. A will start business with an earnings and profits account equal to B's.

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[33] 1954 IRC § 312(b)(2).

[34] 1954 IRC §312(b)(1). This rule insures that generally the value of the inventory asset will be a taxable dividend.

[35] 1954 IRC § 312(d); 1939 IRC § 115(h). 1954 IRC § 312(e); 1939 IRC § 115(c).

[36] 1954 IRC § 312(f); 1939 IRC § 115(l). 1954 IRC § 312(g) and 1939 IRC § 115(m) provide for certain adjustments to the earnings and profits where an increase in value of property accrued before March 1, 1913.

[37] Reg. 118, § 39.115(l)-1.

[38] 1954 IRC § 312(f); 1939 IRC § 115(l); *Commissioner* v. *Wheeler,* 324 U.S. 542, 33 AFTR 595 (1945); *Commissioner* v. *Fisher,* 327 U.S. 512, 34 AFTR 818 (1946).

[39] 1954 IRC § 381(c)(2) codifies the Sansome rule in certain non-taxable corporate acquisitions. *Commissioner* v. *Sansome* (2 Cir. 1932), 60 F. 2d 931, 11 AFTR 854; *Commissioner* v. *Munter,* 331 U.S. 210, 35 AFTR 963 (1947).

(2) Corporation A, owning all the stock of Corporation B, liquidates B and takes over its assets. A must add B's earnings and profits to its own.

A *deficit*, on the other hand, may be used only to offset earnings and profits accumulated after the date of transfer.[40] The 1954 Code modified existing law in this respect. Under the old law, if subsidiary B in example (2) above had an operating deficit, it would be lost in the liquidation; it would not serve to reduce A's earned surplus.[41] But if the transferee (surviving) corporation had the deficit, the liquidation would result in an overall reduction in earnings, since the earnings and profits of the transferor (expiring) corporation would be absorbed or offset, partially or wholly, by the transferee's deficit.[42] The 1954 Code provides that in either case the deficit shall be used only to reduce future earnings and profits.

The 1954 Code also provides for an increase in earnings and profits by the excess of a government insured loan over the adjusted basis of the property constituting the security for such loan immediately prior to any distribution made after June 22, 1954 and for a decrease in the earnings and profits by such excess immediately after the distribution.[43]

The company's regular method of accounting (cash, accrual, installment) is followed in all calculations involving the earnings and profits account.[44]

5. Cash Dividends

The problem most commonly encountered in connection with such a dividend is whether the corporation has sufficient current or accumulated earnings to cover it. If it has, the distribution is fully taxable to the shareholders (subject to the dividend received exclusion and credit). To the extent that it is not taxable, it represents a return of capital, and after the basis of the stock is recovered, capital gain.

The doctrine of constructive receipt is of course as applicable to dividends as it is to salaries, interest, and other items of income.[45] If instead of issuing checks to its shareholders the corporation credits their respective accounts so that the amounts are subject to withdrawal at any time, a dividend has been paid and received. The issuance of corporate obligations by a solvent corporation will likewise be treated as the equivalent of cash.

Where obligations (bonds or debentures) are distributed to shareholders, as part of reorganization, recapitalization or a spin-off of a subsidiary and the principal amount of the securities received exceeds the principal amount of any securities surrendered by the shareholder, such excess will be treated as boot. If the shareholder has a gain on the transaction he will be taxed up to the fair market value of such boot and where the transaction has the effect of a dividend, the gain up to such fair market value will be treated as a dividend.[46] If the corporation has earnings, either current or accumulated, corporate obligations should not be issued to shareholders in exchange for a part of their stock or a lesser principal amount of corporate obligations, unless it is intended that a taxable dividend be paid.

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[40] 1954 IRC § 381(c)(2).

[41] *Commissioner* v. *Phipps*, 336 U.S. 410, 37 AFTR 827 (1949). This decision was criticized in Ralph S. Rice, "Transfers of Earnings and Deficits in Tax Free Reorganizations: The Sansome-Phipps Rule," *Tax Law Review*, May 1950, Vol. 5, page 523.

[42] *Harter* v. *Helvering* (2 Cir. 1935), 79 F. 2d 12, sanctioned by Supreme Court in *Commissioner* v. *Phipps*, 336 U.S. 410 (1949).

[43] 1954 IRC § 312(j). This provision was aimed at builders who derived so-called "windfall profits" under the Federal Housing Administration programs by obtaining insured mortgage loans in excess of the cost of constructing housing projects and then distributing the excess mortgage proceeds before the corporation had any earnings or profits from operations. However, the code provision has a wider application.

[44] Reg. 118, § 39.115(a)-2; *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 36 AFTR 604 (1948).

[45] Reg. 118, § 39.42-3. See *Aramo-Stiftung* v. *Commissioner* (2 Cir. 1949), 172 F. 2d 896, 37 AFTR 958, where the identity of the true owners was not known at the time the dividends were paid. But see *Maurice Fox*, 20 T.C. No. 150 (1953) (acq.).

6. Property Dividends (Not Including Stock of the Distributing Corporation)[47]

The amount of any dividend in kind to a noncorporate shareholder is the fair market value of the property received [48] and the same value determines the basis of the property in the shareholder's hands.

If the shareholder is a corporation the amount of the dividend is the lesser of (1) the fair market value of the property, or (2) the adjusted basis of the property in the hands of the distributing corporation (increased in the amount of gain recognized if the property is LIFO inventory or subject to a liability in excess of basis). The same amount determines the basis of the property in the corporate shareholder's hands.[48]

From the shareholder's point of view the main problem is valuation. In the absence of a market price (for instance where shares of a closely held subsidiary are distributed) there is likely to be a difference of opinion between the shareholders and the Commissioner on this point. If the corporation's earnings and profits, current and accumulated, exceed the adjusted basis of the property distributed, the full market value of the property is taxed to the noncorporate shareholder as a dividend and the full amount of the dividend (market value or adjusted basis, as the case may be) is taxed to the corporate shareholder.[49] Generally, in computing the earnings and profits for this purpose the distribution of appreciated property does not in itself increase earnings and profits but on the distribution the earnings and profits are decreased only by the adjusted basis of the property distributed.[50]

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[46] 1954 IRC § 356(a).

[47] 1954 IRC § 317(a).

[48] 1954 IRC § 301(b), (d); 1939 IRC § 115(j).

[49] *Commissioner* v. *Fannie Hirshon Trust* (2 Cir. 1954), 213 F. 2d 523, reversing par. 53, 106 Prentice-Hall Memorandum T.C. (1953); *Commissioner* v. *Godley* (3 Cir. 1954), 213 F. 2d. 529, reversing 19 T.C. 1082 (1953). 1954 IRC §§ 301(c)(1), 312(a) and 316(a) certainly strengthen the application of the Godley and Hirshon result to distributions governed by the 1954 Code. Before the 2nd and 3rd Circuits reversed the Tax Court in Godley and Hirshon and before the enactment of the 1954 Code, the Tax Court consistently held that the property dividend was taxable to the extent of its fair market value but never in excess of the corporation's earnings and profits. Godley and Hirshon do not decide the case where the earnings and profits of the corporation are less than the adjusted basis of the appreciated property distributed, but the indicated result is that the non-corporate shareholder will be taxed as a dividend in an amount which bears the same ratio to the fair market value of the property as the corporation's earnings and profits bear to the adjusted basis of the property.

[50] 1954 IRC § 312(a). But compare 1954 IRC § 312(b),(j) as to the distributions of certain inventory assets or proceeds of a loan insured by the United States.

Example: X Company owns stock in Y Company that it purchased in 1940 for $10,000. In 1955 X distributes the Y stock, now worth $20,000, to its shareholders. X has no prior years' accumulated earnings; its earnings for 1955 are $12,000. The X shareholders are taxable on the $20,000 (in value) distributed to them. X's earnings and profits of $12,000 is reduced by $10,000 (the cost of the Y stock) as a result of the distribution.

From the corporation's viewpoint the problem is whether the property distribution gives rise to income taxable to the corporation. It is clear that, except in the case of installment obligations, LIFO inventory and property subject to a liability which exceeds its basis, no gain or loss is recognized to the corporation upon a property distribution. Accordingly, X Company, in the above example, realized no gain or loss by distributing the Y stock.[51] On the other hand, if X's directors had declared a cash dividend of $20,000 and had then discharged it by distributing the appreciated Y stock valued at $20,000, the distribution would have been treated as equivalent to a sale of the stock by X, the proceeds being applied in discharge of X's $20,000 obligations to its shareholders. X would have been taxed on a $10,000 capital gain.[52] This danger should be borne in mind when you draft the resolution providing for a dividend in kind. Make sure that the corporation is not committing itself to a dollar obligation.

This same unhappy result—a tax on both corporation and shareholder—may occur where the property represents "potential gain or income." Gain is recognized under the 1954 Code to a corporation on the distribution of installment obligations, LIFO inventories and property subject to a liability in excess of basis.[53] In the case of a distribution of notes which have been written off in prior years with tax benefit or royalties temporarily assigned, the corporation is taxed on the payments received by the shareholder after the distribution by analogy to the assignment-of-income cases.[54] The shareholder is also taxed. He has received a taxable dividend.

A similar risk was involved prior to the enactment of the 1954 Code where property distributed in liquidation of a corporation is sold by the shareholders shortly after its receipt. The Supreme Court in *Commissioner* v. *Court Holding Company*[55] held that under certain circumstances a sale by shareholders may be transformed for tax purposes into a sale by the corporation. Then, in *Cumberland Public Service Co.* v. *United States,*[56] the Supreme Court decided that a sale of property by shareholders following a "genuine liquidating distribution" cannot be attributed to the corporation for tax purposes regardless of the motive for the liquidation. The 1954

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[51] 1954 IRC § 311. Section 311(a) has no counterpart in the 1939 Code but incorporates the general rule of *General Utilities & Operating Co.* v. *Helvering,* 296 U.S. 200, 16 AFTR 1126 (1935).

[52] *Callanan Road Improvement Co.,* 12 B.T.A. 1109.

[53] 1954 IRC §§ 311, 453(d).

[54] The Senate Committee Report on the 1954 Code at page 247 indicates that section 311 is not intended to change the existing law with respect to attribution of income of shareholders to their corporation as in the case of *Commissioner* v. *First State Bank of Stratford* (5 Cir. 1948), 168 F. 2d 1004, 36 AFTR 1183; *Rudco Oil & Gas Co.* v. *U.S.* (Ct. Cls. 1949), 82 F. Supp. 746, 37 AFTR 1099.

[55] 324 U.S. 331 (1945).

[56] 338 U.S. 451 (1950). This case is noted in *Harvard Law Review,* March 1950, Vol. 63, page 871, where it is suggested that the decision of the Court might be based on procedural grounds. See *Oahu Beach & Country Homes, Ltd.,* 17 T.C. 1472 (1952) where the Tax Court followed the *Cumberland Public Service Co.* case when property was distributed to stockholders after federal condemnation proceedings had begun but before title had passed pursuant to the filing of the declaration of taking.

Code eliminates the necessity of conforming to legal formalities in avoiding the double tax in these situations. The Code now relieves the corporation from tax, even though *it* may have sold the property, provided the property is sold within 12 months after adoption of a plan of complete liquidation, and liquidation is completed within 12 months after adoption of the plan.[57] The corporation will, however, still be taxed on its sale of inventory (unless sold in bulk to one person) and certain installment obligations. The relief provision is inapplicable to collapsible corporations and where shareholders elect not to be taxed on unrealized appreciation.

The Commissioner in the past has sometimes contended that a corporation realizes gain in distributing property which is thereafter sold by the shareholders on the theory that the distribution had no business purpose and that it was really the corporation that made the sale and realized the profit.[58] The enactment of 1954 IRC § 311 may deter the Commissioner from using the business purpose test to enlarge the statutory provisions for recognition of gain or loss to a corporation on distributions with respect to its stock.

7. Stock of Distributing Corporation

Stock dividends payable in stock of the distributing corporation or rights to acquire such stock are now nontaxable unless distributed in discharge of preferred stock dividends of the current or preceding year.[59] An election available to any of the shareholders to take cash or other property instead of stock will make the distribution taxable, even though all the shareholders elect to receive stock of a type which would otherwise be non-taxable.[60]

Taxability of stock dividend prior to June 18, 1954—the proportionate interest test. Before the enactment of the Revenue Code of 1954, taxability of a stock dividend depended on whether it changed the proportionate interests of the shareholders in the corporation.[61] If the proportions remained the same, the issuance of the new stock was non-taxable. The theory was that the shareholder's investment in the enterprise had been changed in form only. The shareholder held a few more shares, but so did everyone else. A dividend of common on common was the simplest example,[62] but a dividend payable in stock of a different class could also be non-taxable if the proportionate interest test was met.[63] A taxable stock dividend, on the other hand, was usually one that changed the proportionate interests of the shareholders.[64] The commonest example of the latter type was a dividend to common shareholders payable in preferred stock of a class already outstanding.[65]

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[57] 1954 IRC § 337.

[58] U.S. v. *Lynch* (9 Cir. 1951), 192 F. 2d 718 where the dividend was in inventory of the distributing corporation which was promptly sold by the stockholders and the Court taxed the net profits to the corporation because the transaction was "outside the range of normal commercially-motivated and justifiable corporate activity." See *Transport, Trading and Terminal Corp.* (2 Cir. 1949) 176 F. 2d 570, 38 AFTR 365; but see *Ripy Bros. Distillers, Inc.* 11 T.C. 326 (1948).

[59] 1954 IRC § 305.

[60] 1954 IRC § 305(b)(2); 1939 IRC § 115(f)(2).

[61] On the general subject, see Burton W. Kanter, "The Present Tax Status of Stock Dividends," *Taxes*, June 1953, Vol. 31, page 418.

[62] *Eisner* v. *Macomber*, 252 U.S. 189, 3 AFTR 3020 (1920); *Helvering* v. *Griffiths*, 318 U.S. 371, 30 AFTR 403 (1943).

[63] *Strassburger* v. *Commissioner* decided with *Helvering* v. *Sprouse*, 318 U.S. 604, 30 AFTR 1087 (1943); See *Wiegand* v. *Commissioner* (3 Cir. 1952), 194 F. 2d 479, reversing 14 T.C. 136 (1950) which previously had been affirmed on the original hearing; *Tourtelot* v. *Commissioner* (7 Cir. 1951), 189 F. 2d 167.

Taxability of stock dividend after June 18, 1954. The Revenue Code of 1954 enacted a new general rule that the distribution of a stock dividend is nontaxable whether or not a particular shareholder's proportionate interest in the corporation is changed.[66] However, such stock (other than common on common) acquires a tag "section 306 stock"[67] and dividend tax may be imposed on the subsequent disposition of section 306 stock.[68]

Allocation of basis.[69] Assuming that a stock dividend is non-taxable, complications arise when the shareholder sells some of his stock, new or old, or sells his rights to subscribe instead of exercising them. The shareholder's gain or loss in the sale transaction, and in any subsequent sale of his remaining stock, will depend upon the allocation of his basis or cost between the stock or rights that he sells and the stock that he retains. His original investment in the corporation remains unchanged, but with the issuance of the dividend stock, this investment is represented by additional shares. The shareholder's cost or other basis must in some way be spread over all his holdings, new and old, and a new per share basis must be determined.[70]

The operation of the rules for allocation of basis[71] in connection with nontaxable stock dividends may best be illustrated by examples. Assume that the taxpayer holds 100 shares of common stock (in each of the corporations mentioned below) that he purchased in 1946 for $10 per share, or $1,000.

Examples: 1. The A Corporation issues a 10 per cent stock dividend payable in common stock, one share for ten. He now owns 110 shares still at a cost of $1,000 and his new per share basis is $9.09. His gain or loss upon a subsequent sale of either new or old stock will be computed on this basis. The same formula would of course apply to fractional shares. If, for example, the dividend had been one share for eight (instead of ten) the taxpayer would have received twelve new whole shares and a scrip certificate for one-half additional share, and would now own 112.5 shares at $8.88 per share or $4.44 for the scrip. Sale of the scrip at $6 will produce a taxable gain of $1.56.

2. The B corporation with only common outstanding issues a preferred stock dividend one share of $10 par preferred for each ten shares of common. The taxpayer's cost is still $1,000. The allocation of this cost between his 100 shares of old common and his 10 shares of new preferred is based upon the relative values of the two classes at the time of issuance. If the market value of the common (ex-dividend) is $15 (or $1500 for 100 shares) and of the preferred $12 (or $120 for 10 shares), the preferred represents 120/1620 of the total value, or 7.4 per cent, and the common the rest, or 92.6 per cent. The taxpayer's basis of $1,000 is allocated accordingly: to the 10 shares of pre-

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[64] *John A. Messer, Sr.*, 20 T.C. No. 31 (1953).

[65] Where there are two classes outstanding the stock dividend may nevertheless be nontaxable if both the original classes are held by all stockholders in the same proportions. See *Tourtelot v. Commissioner* (7 Cir. 1951), 189 F. 2d 167.

[66] 1954 IRC § 305. There are two exceptions to the general rule set forth in 1954 IRC § 305(b).

[67] 1954 IRC § 306(a). See chapter entitled "Current Restrictions on Stock Dividends."

[68] 1954 IRC § 306(b)(c).

[69] Parts of the following material on apportionment of basis are from a note by Joseph S. Platt that appeared in the February 1949 issue of the *American Bar Association Journal*. This material is reprinted by permission of the Journal.

[70] 1954 IRC § 307.

[71] 1954 IRC § 307; 1939 IRC § 113(a)(19)(23). Reg. 118, §§ 39.113(a)(19)-1 and 39.22(a)-8.

ferred, 7.4 per cent or $74, or $7.40 per share; to the 100 shares of common, 92.6 per cent or $926, or $9.26 per share.

3. The C Corporation issues, after June 18, 1954, rights to subscribe for one share of additional common stock for each 10 shares owned, at a price of $10 per share. The common is now worth $15 per share (ex-rights) and the rights applicable to the purchase of one new share are salable at $5. The allocation of the taxpayer's $1,000 cost again depends upon these relative values. His rights to purchase 10 new shares are worth $50 and his 100 shares of old common are worth $1500. Since the value of the rights is less than 15 per cent of the value of the old common, the basis of the rights is zero and a sale at $50 will produce a taxable gain of $50.

If the taxpayer elects in his tax return to allocate the cost of the old common between the rights and the old common, and in every distribution where the value of the rights is 15 per cent or more of the value of the old stock, the allocation is made in the following manner.[72] The value represented by the rights is 50/1550, or about 3.2 per cent of the whole, and the $1,000 cost is allocated: to the rights, 3.2 per cent of $1,000 or $32; to the old common, 96.8 per cent of $1,000 or $968, or $9.68 per share. A sale of the rights at $50 will produce a taxable gain of $18. If the taxpayer exercises the rights, he will pay $100 (the subscription price) and receive ten new shares. The basis of these new shares will be $100 (the amount paid) plus $32 (the basis of the old shares allocated to the rights), that is, $132, or $13.20 per share.

The complications are multiplied where the original stock was purchased at different times and different prices. The identification of particular shares of the dividend stock with particular blocks of the original stock presents practical difficulties, since the dividend stock is normally issued in one certificate. In the absence of identification, should a sale of part of the dividend stock (a scrip certificate, for example) be attributed to the earliest purchase under the first-in-first-out rule, or may the taxpayer use the average per share basis for all the dividend stock? The Regulations prescribe the former rule (first-in-first-out), but the averaging method is usually easier to apply.[73]

Example: The taxpayer purchased his original 100 shares of common stock in Corporation A, 60 shares in 1945 at 10 ($600) and 40 shares in 1946 at 12 ($480). He receives a 12½ per cent stock dividend, one share for eight, and now owns 112½ shares.

Under the averaging method the per share basis of the new stock would be $9.60 ($1080/112.5), or a basis for the 12½ shares of $119 ($9.60 × 12½). This basis represents about 11 per cent of the total basis ($1080) and the basis of each original block should accordingly be reduced by 11 per cent.

Under the first-in-first-out method it would be assumed that the taxpayer had received 7½ shares on his first block (60 × 12½ per cent) and 5 shares on his second block (40 × 12½ per cent) and a separate computation would be made in respect to each. Sale of anything up to 67½ shares would be chargeable (in the absence of identification) against the basis of the first or 60-share block.

Consistency in this area is probably more important than the precise rule adopted. If the taxpayer uses the same method year after year in allocating his basis it is unlikely that his computations will be disturbed.

One further quirk should be mentioned in connection with non-taxable stock dividends. The holding period of the dividend stock and rights goes back to the acquisition date of the original stock.[74] This means that if the original stock has been held more than six months any gain from the sale—even the immediate sale—of the dividend stock or rights (other than section 306 stock) will be "long-term" and only 50 per cent taxable. But there is one catch: if rights are issued and exercised, the holding period of the stock so acquired starts with the date of exercise, even though the rights which were turned in for part of the purchase price had a much longer holding period.[75]

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[72] 1954 IRC § 307(b)(c). With respect to all stock rights distributed before June 18, 1954 it is necessary to make the basis allocations between the stock and the rights regardless of the value of the rights.

[73] Reg. 118, § 39.113(a)(12)-1, made applicable by regulations cited in footnote 71.

[74] 1954 IRC § 1223(5); 1939 IRC § 117(h)(5).

The nuisance factor involved in a small non-taxable stock dividend is extremely heavy and you may be tempted, at least in the case of the scrip, to treat the proceeds as a taxable cash dividend. Do not succumb to this temptation. The only result will be to overpay your tax for the current year. The new stock and the scrip have carried away a part of your original basis, whether you like it or not, and when you eventually sell your old shares you will find your gain increased accordingly. The taxpayer has no election to treat such dividends as taxable.

The 1954 Code, however, has eliminated the necessity under prior law to make negligible basis allocations in the case of distribution of stock rights on and after June 18, 1954. Under the rule the basis of the rights is zero unless the taxpayer elects to allocate or unless the value of the right is 15 per cent or more of the value of the stock at the time of distribution, in which event the allocation must be made.[76]

There is another way to avoid all the complex allocation-of-basis problems discussed above: Do not sell any of your holdings in a corporation which has issued non-taxable stock dividends until you are ready to sell them all. This includes scrip and rights as well as whole shares. Always exercise the rights and purchase the necessary additional scrip to eliminate fractional shares, and (in order that all your holdings may be long-term) do not sell anything until at least six months after the exercise of the rights. Then, when you sell out all your stock, you need only add up all the amounts you have paid, both for the original stock, and upon the exercise of rights and the purchase of scrip, and the result will be your basis for the determination of gain or loss on the sale. This would also avoid the "section 306 stock" problem if ownership of stock in that corporation by others is not attributed to you under the attribution rules in 1954 IRC § 318(a).[77]

8. When Dividend Income is Realized

Formal dividend procedure involves three dates; the declaration date (when the directors determine to pay a dividend), the record date (when the stockholders entitled to receive the dividend are determined), and the payment date (when dividend checks are mailed or delivered to shareholders of record on the record date). A cash-basis shareholder realizes income when he receives his dividend check, not before. If the dividend checks are mailed on December 31, 1954 and received on January 2, 1955, the shareholders realize income in 1955.[78] This assumes, of course, that there has been no prior constructive receipt, as where the dividend has been credited to the shareholder's account and made unqualifiedly subject to his demand.[79]

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[75] 1954 IRC § 1223(6); 1939 IRC § 117(h)(6).

[76] 1954 IRC § 307(b).

[77] 1954 IRC § 306(b)(1).

[78] Reg. 118, § 39.42-3; *Avery* v. *Commissioner*, 292 U.S. 210, 13 AFTR 1168 (1934); *Maurice Fox*, 20 T.C. No. 150 (1953).

One might expect that the rule would be different where the shareholder is on the accrual basis, but such is not the case. The date of receipt, not the declaration date, is still decisive in determining when dividend income is realized.[80]

9. To Whom Dividend is Taxable

Sale of the stock prior to the declaration date deflects the dividend to the purchaser.[81] Where the selling price reflects an anticipated dividend, this is a means of converting dividend income into capital gain.[82] This result is not so clear where the sale is made after the declaration date but before the record date.[83] If the stock is sold ex-dividend after the record date, the dividend is actually received and retained by the seller as record owner, and naturally is taxable to him. Where the sale is made after the record date and the dividend is paid to the purchaser[84] under an agreement to account to the purchaser for the dividend, a definite portion of the purchase price may be attributed to the dividend, and the Commissioner may with some justification assert a tax against the seller on this portion as representing the proceeds of an item of income. In such event the income would be realized when the purchase price was received, not at the later dividend payment date.

The purchaser must ordinarily capitalize the entire purchase price, even though a portion of his payment represents the value of an anticipated dividend.[85] When the dividend is received it is fully taxable and may not be treated as a return of capital. The result should be otherwise in the situation mentioned above where a definite portion of the purchase price may be taxable to the seller as the proceeds of the dividend. In such event the purchaser has bought an account receivable and should be permitted to offset its cost against the amount of the dividend when it is received.[86]

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[79] *Kunze* v. *Commissioner*, 19 T.C. 29 (1952) aff'd *per curiam* 203 F. 2d 957 (2 Cir. 1953).

[80] *American Light & Traction Co.*, 3 T.C. 1048 (1944), affirmed (7 Cir. 1946) 156 F. 2d 398, 34 AFTR 1544.

[81] I.T. 2569, X-1CB 101.

[82] Reg. 118, § 39.22(a)-1.

[83] See *Putnam Estate* v. *Commissioner*, 324 U.S. 393, 33 AFTR 599 (1945) where the issue arose on the construction of "accrual" under Section 42, Revenue Act of 1938 and the court held that where a stockholder died between the declaration date and the record date, the dividend was not "accrued up to the date of his death." The language and *dicta* of the decision, however, indicate that the dividend was taxable to the estate of the decedent, which was the owner of the stock on the record date. See also *George McNaught Lockie*, 21 T.C. No. 8 (1953); *Merritt J. Corbett Estate*, 12 T.C. 163 (1949).

[84] See *Tar Products Corp.* v. *Commissioner* (3 Cir. 1942) 130 F. 2d 866, 29 AFTR 1190.

[85] Reg. 118, § 39.22(a)-1. See *DeGuire* v. *Higgins* (2 Cir. 1947), 159 F. 2d 921, 35 AFTR 868, where the stock was held in escrow under an option contract. The dividends, which were applied on the purchase price, were taxed to the purchaser, even though he was not legally bound to complete the purchase. See *Northern Trust Co. of Chicago* v. *United States* (7 Cir. 1951), 193 F. 2d 127. But see *Jeanette W. FitzGibbon*, 19 TC 78 (1952) where the *bona fides* of the transaction were in issue.

[86] *Gladstone Co.*, 35 B.T.A. 764 (1936).

10. Repayment or Rescission of a Dividend

Once a dividend has been paid it is taxable to the shareholders, even though they subsequently return all or a portion of it to the corporation. The repayment of the money is a contribution to capital; it simply increases the basis of the shareholder's stock. This result is clear where the repayment is entirely voluntary. The rule is probably the same where the dividend is received under a "claim of right," even though later found to be in violation of a contract commitment.[87] In such event, however, where it develops that the shareholder is under a legally enforcible obligation to repay the dividend, he ought to be allowed a deduction in the year of repayment.[88] It should be open to the directors, presumably with consent of the shareholders, to rescind the declaration of a dividend at any time before payment, and thereby relieve the shareholders of the tax. There is an early Board of Tax Appeals decision to the contrary,[89] however, and one cannot be certain that such a transaction would not be treated as a taxable dividend plus a contribution to capital. As a practical matter a dividend should not be declared unless it will be paid.

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[87] *St. Regis Paper Co.* v. *Higgins* (2 Cir. 1947) 157 F. 2d 884, 35 AFTR 334. See *Knight Newspapers, Inc.* v. *Commissioner* (6 Cir. 1944) 143 F. 2d 1007, 32 AFTR 1111.

[88] See 1954 IRC § 1341.

[89] *J. A. Swanson,* 2 B.T.A. 1112 (1925).

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Part VII

MAKING SALES AND EXCHANGES

54

General Outline of Tax Considerations in Sales Decisions

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The broad scope of this subject encompasses many economic and business considerations not dealt with here. The entire array of facts and considerations, in any situation, must be carefully analyzed in the light of the tax possibilities under the law. Glittering probabilities often become very unwise. However, an outline of the principal tax considerations in making the sale, together with the possible alternatives for a client seeking your tax advice on a proposed sale of property or business, should be helpful.

1. Points to Consider

Before a consideration of the suggested tax alternatives, the following preliminary analyses should be made:

	Section
Does ordinary income or loss, or capital gain or loss result? What is being sold?	2
If capital gain or loss results, is there a long term or short term gain or loss?	2
Who is the seller? Is there a better seller?	2

After you have analyzed the probable tax results of the proposed sale, attention should be given to the selection of the proper year for sale. Your choice of the proper year may depend on all of the answers to the following questions:

	Section
Can you take gains or losses in a year when offsetting losses or gains are available?	3
Effect of capital gain or other gain on deduction for medical expense (if individual taxpayer)	3
Is the charitable gifts deduction increased?	3
Is a net operating loss carry over available which will be affected by any gain on the sale?	3
Effect on credit for foreign taxes	3
Effect on special exemptions afforded for: (a) Dividends paid by domestic corporation to nonresidents. (b) Income from U.S. possessions. (c) Western hemisphere corporations	3
If a dividend can be declared as a nontaxable return of capital, can you postpone realization of gain until following years?	3
Can full utilization be made of ordinary loss on depreciable property against ordinary income rather than offsetting the loss	

Section
against net gains from appreciated property taxable only at a 25 per cent rate? 3

Before a final decision to sell is made, the prime alternatives possible under the facts should be critically examined. Some alternatives, together with their tax advantages, are outlined for your guidance:

Section
Loans on the property 4
Sale and lease-back 4
Exchanges of property for other property 5
Leases 6
Abandonment 7
Executory contracts and other sale arrangements 8

Further analysis of related considerations in making sales and exchanges and in dealing with particular sales are discussed in the following Chapters: installment sales and deferred payment sales in "Deferring Sales to Another Period," and sale of realty in "How to Buy and Sell Real Estate"; sale of partnership interest instead of individual assets in "Converting Income to Capital Gain," and distribution of assets by a corporation and sale of the assets by stockholders in "Who Should Sell—Stockholder or Corporation."

2. Preliminary Analysis of Proposed Sale

Usually the nature of the property sold determines whether or not ordinary income or loss, or capital gain or loss results from the sale.[1] It is necessary to decide whether the property is a capital asset as defined in Section 1221 (formerly Section 117(a), 1939 Code), or property used in the trade or business within the meaning of Section 1231 (formerly Section 117(j), 1939 Code). The following general categories of property constitute a guide:

Class of Property	*Result of Sale*
Stock in trade or other property includible in inventory, *or* property held primarily for sale to customers in the ordinary course of business[2]	Ordinary income or ordinary loss
Depreciable business property or real property used in trade or business held for six months	Capital gain on net gains or ordinary loss on net losses.[3]
All other kinds of property, that is, capital assets.	Capital gain or capital loss.

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[1] The determination of whether property is a capital asset is difficult in some cases because the test is not the nature of the property, but is one of relationship or use of the property by the taxpayer. One of the most important considerations is to determine whether the seller is an investor, dealer or trader. See chapter: "When to Be a Trader, Dealer, or Investor."

[2] The following are excluded from the definition of capital assets under the provisions of 1954 IRC Sec. 1221: (a) copyrights and literary, musical and artistic compositions or similar property held by the creator, or by a taxpayer in whose hands the basis of the property is determined by reference to the basis in the hands of the creator; (b) accounts or notes receivable acquired in the ordinary course of business for services rendered or from sale of stock in trade, inventory or property held for sale to customers; and, (c) obligations of the U.S., its possessions, States and Territories and their political subdivisions, and the District of Columbia, issued at discount on or after March 1, 1941 and payable without interest at a fixed maturity not exceeding one year from issue date.

[3] Since the Revenue Act of 1951, a gain will be taxed as ordinary income where it arises from a sale or exchange of depreciable assets between a husband and wife or between an individual

In the event of a disposal of a business or a part of business assets, it is important to classify these assets at the outset. For example, a trade name is a capital asset. Debts, trade acceptances and bank deposits, etc., are ordinarily capital assets.[4] A sale of inventory in bulk results in ordinary income or loss, even though the taxpayer intends to liquidate it.[5] Copyrights, trade marks, patents, and similar assets owned by a business may sometimes be depreciable business property and subject to the provisions of Section 1231 (formerly Section 117(j), 1939 Code).[6] However, patents are usually classified as capital assets; but a copyright in the hands of the writer is not a capital asset. Installment payments in the sale of a non-exclusive license to manufacture under a patent, under some circumstances, may be held to be royalties taxable as ordinary income.[7] Good will is considered a capital asset, but if not, it may be depreciable business property.[8] Customers' accounts sold with an entire business result in capital gain or loss.[9] But by the enactment of Section 1221 of the Internal Revenue Code of 1954, sales of accounts receivable result in ordinary gain or loss.[10]

It is necessary in all instances that in order to attain capital gains treatment, there must be a sale or exchange within IRC Section 1222.

The following summary of the limitations applying to short-term and long-term gains or losses must be kept in mind:

1. A capital gain or loss is long-term only if the asset sold has been held for more than six months; likewise, a Section 1231 gain or loss is not realized unless the asset sold, exchanged or involuntarily converted has been held for more than six months.

2. For 1951 and prior years, individuals took all short-term gains or losses into account at 100 per cent, and long-term gains or losses to the extent of 50 per cent, subject to the alternative computation, limiting the maximum tax upon net long-term capital gain to 25 per cent. Under the Revenue Act of 1951, for the year 1952 and subsequent years, and under the Internal Revenue Code of 1954, individuals take both short or long-term gains and losses into account at 100 per cent. A new capital gain deduction, being 50 per cent of the excess of net long-term capital gain over net short-term capital loss, is allowable after the long-term gain is taken into account at 100 per cent. As a result of these changes, the full amount of the

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and a corporation in which such individual has more than 80 per cent control. 1954 IRC Sec. 1239 (formerly Section 117(o), 1939 Code).

[4] *Ralph Perkins*, 41 B.T.A. 1225, affirmed (6 Cir. 1942) 125 F. 2d 150, 28 AFTR 925; but see footnote 2, *supra, re* accounts receivable.

[5] *Grace Bros., Inc.*, 10 T.C. 158 (1948), affirmed (9 Cir. 1949) 173 F. 2d 170, 37 AFTR 1006; *Violet Newton*, 12 T.C. 204 (1949); *Ellen J. Franklin*, par. 47,293 Prentice-Hall Memorandum T.C. (1949).

[6] See Footnote 2, *supra*. *Raymond M. Hessert*, par. 47,301 Prentice-Hall Memorandum T.C. (1947); Rev. Rul. 54-409, I.R.B. 1954-39, 10.

[7] Mimeograph No. 6490, C.B. 1950-1, p. 9, withdrawing acquiescense in *Edward C. Myers*, 6 T.C. 258; *Robert C. Switzer*, par. 54,247 Prentice-Hall Memorandum T.C. (1954). See also: 1954 IRC Sec. 1235; Report of Senate Finance Committee (1954 Code), 83d Cong., 2d Sess., S. Rep. No. 1622 (1954), p. 439; and Rev. Rul. 55-58, I.R.B. 1955-5, 9, confirming Mim. 6490 except as otherwise provided in Sec. 1235.

[8] *Aaron Michaels*, 12 T.C. 17 (1949); see *Williams* v. *McGowan* (2 Cir. 1945), 152 F. 2d 570, 34 AFTR 615.

[9] *Graham Mill & Elevator Co.* v. *Thomas* (5 Cir. 1945), 152 F. 2d 564, 34 AFTR 613.

[10] See footnote 2, *supra*; Report of Senate Finance Committee hearings, Internal Revenue Code of 1954, Sec. 1221 (83d Cong., 2d Sess., S. Rep. No. 1622).

excess of net long-term capital loss over net short-term capital gain is deductible from gross income. The excess of net long-term capital gain, as a result of the alternative computation, is subject to a maximum tax at the rate of 25 per cent.[11]

3. Corporation taxpayers take all gains or losses into account at 100 per cent, subject to an alternative computation, if the net long-term capital gain exceeds the net short-term capital loss, of a flat tax of 25 per cent upon such excess.[12]

4. *Net* capital losses (excess of losses over gains) are limited as a deduction in the case of individuals to $1,000 or the taxpayer's taxable income, whichever is less.[13] Unused net capital losses may be carried over for a period of five succeeding years.[14] The carry-over is treated as a short-term capital loss and is useable to offset net capital gain in each succeeding year, meaning the taxpayer's net gain from sale or the exchange of capital assets. The net loss for the current tax year is applied against the ordinary net income (up to $1,000) before the carry-over can be applied. It will also be noted that since the capital loss carry-over from a prior year is a short-term capital loss in the year to which it is carried, it thus enters into the computation of the long-term capital gain and reduces or eliminates this gain.

5. Corporations cannot deduct capital losses for any year from income other than capital gains, but may carry forward for five years such losses as an offset against capital gains.[15]

In the case of a sale of a sole proprietorship, gain or loss must be computed on each of the assets of the business.[16] This rule invites consideration of a fair and equitable allocation of price among assets thereby controlling the impact of high tax rates.[17]

The same rule applies to the sale of a business by a partnership. The sale of a partnership interest as such is a sale of a single property right, and therefore produces capital gain or loss to the partner, except insofar as the value of the interest is attributable to his share of unrealized receivables and appreciated inventory.[18] The desirability of a prior distribution in kind to the partners is dealt with below.[19]

The problem of the selling of assets by stockholders rather than by a corporation is dealt with elsewhere in this book.[20]

The determination of the precise date of sale or the year of taxation requires an analysis of the type of property, for example, real property, personal property, manufactured goods, or securities, and also an analysis of the application of the local law as to the passage of title or possession.

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[11] 1954 IRC Sec. 1201 (derived from Sec. 117(c), 1939 Code). For taxable years beginning before April 1, 1954, the rate is 26 per cent as to both individuals and corporations; but for taxable years ending prior to April 1, 1951, the rate is 25 per cent.

[12] Ibid.

[13] 1954 IRC § 1211; 1939 IRC § 117(d).

[14] 1954 IRC § 1212; 1939 IRC § 117(e).

[15] 1954 IRC §§ 1211, 1212.

[16] *Williams* v. *McGowan* (2 Cir. 1945), 152 F. 2d 570, 34 AFTR 615.

[17] Cf. *Grace Bros., Inc.*, footnote 5 above; *Fraser* v. *Nauts* (D.C., N.D. Ohio W.D. 1925); 8 F. 2d 106, 5 AFTR 5600; *Estate of Particelli*, par. 52,044 Prentice-Hall Memorandum T.C. (1952).

[18] IRC §§ 741, 751. *Commissioner* v. *Shapiro* (6 Cir. 1942), 125 F. 2d 532, 28 AFTR 1079. G.C.M. 26379, 1950-10 C.F. 58. See however, *Rhett W. Woody*, 19 T.C. 46 (1952); Cf. *Estate of Meyer Goldberg* (2 Cir. 1951), 189 F. 2d 634, affirming 15 T.C. 10, 40 AFTR 761. See also: *Kaiser* v. *Glenn* (6 Cir. 1954), 216 F. 2d 551.

[19] See Sec. 8, this Chapter.

[20] See Chapter on "Who Should Sell—Stockholder or Corporation and How to Do It."

Final tax results will also depend upon the nature of the consideration received.[21] If the buyer pays cash there is no deferment of gain or loss; likewise, obligations which have a fair market value are returned at that value by all taxpayers. If an installment sale is involved, the income may be reported in proportion to the cash payments. If royalty or a "profit right" is given for a capital asset, the seller may report capital gain. The sale may even qualify as a nontaxable exchange under the nonrecognition sections of the Code.[22]

One of the most important considerations is to determine whether the seller is an investor, dealer, or trader. This very important subject is dealt with elsewhere in this book.[23]

It must not be overlooked that losses from certain sales or exchanges are not allowed: a sale or exchange between members of a family; between the individual and his controlled corporation; between two controlled corporations if foreign or domestic holding companies; between settlor and trustee, separate trustees of the same settlor, beneficiary and trustee, beneficiary of one trust and trustee of another trust of same settlor, or trustee and corporation controlled by the trust or by the settlor; and between an organization exempt from tax (under 1954 IRC Section 501) and the person controlling the organization.[24] Likewise, so-called wash sales of substantially identical securities within a 30-day period result in nondeductibility of loss.[25]

Favorable treatment in the case of the sale of a residence was first provided by the Revenue Act of 1951.[26] The Internal Revenue Code of 1954 retained this favorable treatment and in fact liberalized it. Briefly stated, the sale of a taxpayer's principal residence within a year of buying a new residence or the purchase of a new residence within a year prior to the sale of the old one avoids recognition of gain, except to the amount that the adjusted sales price of the old residence exceeds the purchase price of the new one.[27]

3. What to Consider in the Timing of the Sale

The following considerations reflect the consequences, both direct and collateral, that may ensue from the selection of the proper year for sale of assets.

Obviously, the elimination or the minimizing of a tax occurs if gains or losses are taken in a year when offsetting losses or gains are available. No one is happy about wasting a loss that can otherwise be so utilized.

a. Realization of a gain or capital gain can affect substantially the deduction for medical expense.[28] If your client has unusually large medical expenses to be reported, a sale resulting in a gain should be deferred until the following year. Medical expenses deductible are now those which exceed three per cent of adjusted gross income (subject to further limitation as to drugs and medicines). An increase in income will therefore result in a loss of a part or all of the deduction. However, since there is a ceiling for medical expenses ($2,500 to $10,000), the decrease in deduction may not always result if the medical expenses exceed the deductible exemption or the gain is sufficiently small. The loss of deductible medical expenses caused by the increase in adjusted gross income may be offset to some extent by otherwise nondeductible expenses that may be made available.

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[21] These problems are dealt with elsewhere in this book. See: *Helvering* v. *Nibley-Mimnaugh Lumber Co.* (D.C. Cir. 1934), 70 F. 2d 843, 14 AFTR 209; *Burnet* v. *Logan*, 283 U.S. 404, 9 AFTR 1453 (1931); *J. Darsie Lloyd*, 33 B.T.A. 903 (1935); *Commissioner* v. *Hopkinson* (2 Cir. 1942), 126 F. 2d 406, 28 AFTR 1349; *U.S.* v. *Yerger* (D.C., E.D. Pa. 1944), 55 F. Supp. 521, 32 AFTR 855; *George J. Nicholson*, 3 T.C. 596 (1944).

[22] See footnote 46.

[23] See Chapter on "When to be a Trader, Dealer or Investor."

[24] 1954 IRC Sec. 267; 1939 IRC §§ 24(b), (c).

[25] 1954 IRC Sec. 1091; 1939 IRC §§ 118, 113(a)(10).

[26] 1939 IRC § 112(n), added by Sec. 318 of the Revenue Act of 1951.

[27] 1954 IRC § 1034. See Chapter entitled "Purchases and Sales of Residences."

b. A consequence that may have extremely serious results is the effect of a gain or capital gain on a net operating loss carryover. A client having a net operating loss that can be carried back or forward to years of net profits can obtain substantial refunds or reductions that will be lost if a capital gain or other gain is realized because of the reduction in the carryback or carryover. A long-term capital gain reduces the carryback a full 100 per cent of the gain.[29]

Likewise, in the event of an expectancy of an operating loss (arising from new operations, and so forth), the loss carryback will be reduced by the amount of capital gains (including long-term gains) not included in gross income for the year of the gain.[30] For example, a reduction of a net operating loss from $100,000 to $50,000 (representing $50,000 of $100,000 worth of capital gains not included in gross income) may cost your client about $25,000, the tax paid on $50,000 of ordinary income.

c. The credit for foreign tax is limited to a percentage of the United States tax paid. That percentage is computed by dividing the foreign taxable income by the total taxable income. Thus, an increase of net income may destroy at least a part of the credit for foreign taxes.[31]

d. Similarly, the receipt of long-term capital gain or other gain from sources within the United States may reduce the deductions or exclusions granted with respect to Western Hemisphere corporations, income from United States possessions, and dividends paid by certain domestic corporations to nonresident aliens. This is because these deductions or exclusions are dependent upon the maintenance of minimum ratios between gross income from sources without the United States and gross income from sources within the United States. The result is that a capital or ordinary gain may well cost substantially more than 25 per cent if the above noted considerations are affected.[32]

e. If your client, desiring cash from a sale, has control of a company which has neither accumulated earnings nor earnings for the current year, a dividend of such a company may be a nontaxable return of capital.[33] Postponement of the year of sale to permit the distribution of the capital can result in a substantial tax saving.

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[28] 1954 IRC § 213.

[29] 1954 IRC § 172. For tax years ending after December 31, 1953, the net operating loss is carried back two years and forward for five years.

[30] Ibid.

[31] 1954 IRC § 904.

[32] 1954 IRC §§ 921, 922, 931, 861, 871-72.

[33] 1954 IRC §§ 301, 316; Proposed Income Tax Regs. (1954) §§ 1.301-1, 1.316-1, 1.316-2.

f. A very important and often overlooked tax minimization possibility occurs where the property for sale is depreciable property used in business held for more than six months. Suppose there are two kinds of this property—one that has appreciated in value, and the other that has depreciated. You can advise your client of this possibility: Sell the appreciated property in one year with a resultant tax on the gain of 25 per cent, then sell the depreciated property in another year and use the entire loss to offset income taxed at usual rates.[34]

g. The sale of stock in a corporation affords opportunities for tax advantage. A sale after record date of stock plus right to dividend, apparently permits buyer to recover tax for such portion of cost as is attributable to the dividend.[35] Sale between declaration date and record date of the dividend probably requires dividend to be reported as income of purchaser.[36]

h. Of course, if the asset has been held for six months or less, postponement converts short-term gain into long-term gain. Similarly, if the asset is a non-capital asset and is to be sold in a year of high income, postponement is valuable; conversely, if loss is to result and the taxpayer's income is low.

4. Sale and Lease-Back of Property Compared with Borrowing on the Property

The use of "lease-backs" in corporation financing has become a highly commercialized device as a substitute for loan financing. Selective use of the sale and lease-back of property may result in business advantages, along with tax advantages. Indiscriminate use of the lease-back may result in actual tax pitfalls of a serious nature. Transactions between members of a family or between a close corporation and its stockholders are particularly dangerous.[37]

The use of the ordinary commercial channels for a loan on property to prevent an unwise sacrifice of property, or to defer the year of sale, or as a means of financing, has obvious business and tax advantages and affords a convenient alternative to a sale that would otherwise be heavily penalized by taxes.

An interesting comparison may be made between *borrowing on property* or *selling it with a lease-back:*

Sale and Lease-Back of Property	*Loan on Property*
Vendor-Lessee may claim 100 per cent deduction for rental payments	Deduction for interest
Deductions of rental payments over a specified period may be equivalent to accelerated depreciation. Depreciation may thus be taken on whole property including non-depreciable assets like land	Depreciation deduction on depreciable assets

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[34] 1954 IRC § 1231.

[35] Under the Internal Revenue Code of 1939, the pertinent regulations were: Reg. 118, § 39-22(a)-1(d); Reg. 111, § 29.22(a)-1(d). I.T. 4007, 1950 C.B. 1, p. 11. (Regulations 118, approved September 23, 1953, apply only to the taxable years beginning after December 31, 1951. Citations to the corresponding sections in both Reg. 111 and Reg. 118 are given in this Chapter.)

[36] See *Putnam Estate* v. *Commissioner*, 324 U.S. 393, 33 AFTR 599 (1945).

[37] *Helen C. Brown*, 12 T.C. 1095, reversed (3 Cir. 1950) 180 F. 2d 926, 36 AFTR 155; *Catherine G. Armston*, 12 T.C. 539, affirmed (5 Cir. 1951) 188 F. 2d 531, 40 AFTR 460; see Chapter on "Lease-Backs."

Sale and Lease-Back of Property	*Loan on Property*
Sale and Lease-Back usually results in larger immediate funds or larger aggregate capital; piecemeal financing possible	Interest rate will probably be lower than implicit interest in rental payments
Balance sheet will not reflect any indebtedness from transaction; possible notes or comments[38]	Balance sheet will reflect liability of loan
Avoidance of restrictions on debt financing or in preferred stock provisions	Restrictions on amount of debt, consent of stockholders, and so forth, are applicable
Loss of title to property, but with option to purchase possible	Title to property retained

Emphasis should be laid on the "realities" of the sale and lease-back transactions to judge their tax effects.[39] The two important tax effects flow from (1) the recognition of the transaction as a sale, and the consequent gain or loss, and (2) the deductibility of the rental payments from the gross income of the vendor-lessee. To insure the occurrence of these desired effects, you should advise your client of the following:

Dangers	*Possible Result*	*Remedy*
Option to renew lease at rental not commensurate with value of property	Denial of full deductions for rental payments during initial period	Option to renew should be for a fair rental and commensurate with the value of the property at the end of the original term
Option to purchase at unreasonably low price, making its exercise very probable	The entire transaction will be denied the tax effect of a sale, and thus deny any loss and deductibility of rental payments[40]	Sale price, rental, and option to purchase should reflect a price and rental arrived upon at arm's length dealings under market conditions
Term of 30 years or more where there is a capital loss on the sale	Transactions will be held to be an exchange of property of like kind under IRC Sec. 1031, and capital loss deduction from the sale will be denied.[41]	Term of lease should be of less duration than 30 years

Other criteria to be applied in making decisions in these cases are:[42]

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[38] Cf. Rule 3-20, Amending Regulation SX, Securities and Exchange Commission.

[39] See *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 33 AFTR 593 (1945); *Griffiths* v. *Commissioner*, 308 U.S. 355, 23 AFTR 784 (1939).

[40] See I.T. 1819, II-2 C.B. 122 (1923); *Higgins* v. *Smith*, 308 U.S. 473, 23 AFTR 800 (1940); *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252, 23 AFTR 778 (1939).

[41] 1954 IRC § 1031; Reg. 111, § 29.112(b)(1)-1; Reg. 118, § 39.112(b)(1)-1; *Century Electric Co.* v. *Commissioner* (8 Cir. 1951), 192 F. 2d 155. Cf. *Standard Envelope Mfg. Co.* v. *Commissioner*, 15 T.C. 41 (1950). See also Sec. 5 of this Chapter.

[42] *Judson Mills* v. *Commissioner*, 11 T.C. 25 (1948); *Chicago Stoker Corp.* v. *Commissioner*, 14 T.C. 441 (1950); *May Dept. Stores Co.* v. *Commissioner*, 16 T.C. 547 (1951); *Helser Machine & Marine Works, Inc.*, 39 B.T.A. 644 (1939); *Benton* v. *Commissioner* (5 Cir. 1952), 197 F. 2d 745; *Holeproof Hosiery Co.*, 11 B.T.A. 547 (1928); *Calcasieu Paper Co., Inc.*, par. 53,085 Prentice-Hall Memorandum T.C. (1953); *William A. McWaters, et al.*, par. 50,152 Prentice-Hall Memorandum T.C. (1950); *Breece Veneer and Panel Co.*, 22 T.C. No. 172 (1954); *East Coast Equipment Co.*, 21 T.C. 112 (1953); *S. P. McCall*, pars. 53,338, 53,388, 54,138 Prentice-Hall Memorandum T.C. (1953); Rev. Rul. 55-25, I.R.B. 1955-3, 63.

Is the buyer-lessor an exempt or non-exempt taxpayer?
Is the transaction bona fide?
What is the relationship of the market price to the sale price?
Are there good business reasons for the arrangement?
Does the seller-lessee have an equity in the property?

Purchasers of property under lease-back arrangements are often tax-exempt institutions such as colleges and universities; some are partially tax-exempt, such as insurance companies. The rentals received by these vendee-lessors are not taxable income, and therefore they are indifferent to the characteristics of such a transaction as a loan or a sale with a lease.

However, if there is outstanding any unpaid indebtedness arising from the acquisition or improvement of the rental property, and if the lease was entered into for reasons not substantially related to the primary purposes of the institution, rentals received by many tax-exempt institutions may be taxable at least in part where (1) the term of the lease is more than five years (including periods subject to the lessee's option for renewal); and (2) where the property has been occupied by the same lessee for a total period of more than five years.[43] In the latter case, rental income is taxable only in the sixth and succeeding years of occupancy. An exception to the rule permits such institutions to escape taxation if more than 50 per cent of the rentals are received from tenants (occupying more than 50 per cent of the area of the property) not under leases for more than five years, *and* no one tenant under a lease for more than five years pays more than 10 per cent of the rent received or occupies more than 10 per cent of the area.[44] The Treasury's close scrutiny of these transactions may be expected.[45]

The larger availability of all kinds of capital equipment for lease has intensified interest in the comparison between the purchase or lease of equipment. At the same time the new and more rapid depreciation methods made possible by the 1954 Code have affected the answer of the inquiring purchaser or lessee. The business considerations generally considered in making this decision are: (a) leasing and installation cost, (b) annual service, maintenance, insurance or other charges, (c) capital charges, (d) annual depreciation, (e) loss in value—used equipment value, (f) heavy obsolescence factor, (g) tax savings, (h) actual cost after taxes.

In certain businesses special factors such as need for cash, or the effect of heavy obsolescence may be conclusive. A comparison of the annual rental deductions with the depreciation allowance generally will reflect the tax savings at the rate applicable. It is imperative in any given transaction that a determination be made that rental payments are actually deductible, and in this connection the authorities cited in footnote 42, supra, should be consulted. The courts have generally used two criteria to determine if a given transaction is a lease or a sale. One test has been called the "objective economic test," and the other test is known as that of the "parties' intention." An evaluation requires (a) a comparison of interim rent to rental value, (b) a comparison of option price to anticipated value of property, and (c) a determination as to whether or not the payor obtains any equity in the property with each payment.

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[43] 1954 IRC §§ 501, 514.

[44] 1954 IRC § 514.

[45] See article by William L. Cary, "Sales and Lease Back of Property," *Proceedings of New York University Seventh Annual Institute on Federal Taxation*, page 599. New York: Matthew Bender and Company, 1948. See also George R. Blodgett, "Taxation of Business Conducted by Charitable Organizations," *Proceedings of New York University Fourth Annual Institute on Federal Taxation*, page 418. New York: Matthew Bender and Company, 1945.

5. Exchange of Property for Property

The first tax question in any sale or other disposition of property is whether realized gain or loss is recognized. Exchanges are often preferable to a sale, for many exchanges of property come within the provision of the nonrecognition sections of the Code,[46] and no tax results from the exchange.

To be free from tax, under IRC Section 1031, the exchange must be, as to the property given up and the property received, (a) property that is held for "productive use in trade or business or for investment," and (b) the property given up and the property received must be of like kind, which means like property of the same general character but not necessarily identical as to grade or quality.

Stock in trade, securities, and property held primarily for sale are not held for "productive use in trade or business." [47] Likewise, residential property and ordinary business sales by dealers in real estate or personal property do not qualify.[48]

On the other hand, unimproved real estate may be exchanged for improved real estate.[49] An exchange of an undivided interest in oil and gas for an undivided interest in an improved city lot, is non-taxable.[50] It is possible for the seller to transfer the property to the buyer, provided the buyer causes a direct conveyance to the seller from another party.[51]

An exchange may be practical as a substitute for a taxable sale in certain instances. For example, the exchange of a fully depreciated automobile or a business automobile can be advantageous if a new one is purchased, because the trade-in will postpone the tax.[52] Of course, if the 25 per cent tax is paid, a larger depreciation basis may be used.

Thus, if appreciated property is involved, the exchange of such property for like property postpones the tax until the like property is disposed of.[53] If cash is received in addition to the property, it will be taxable as boot,[54] only to the extent of the gain on the property that is given up.

If the realized gain or loss is recognized from the exchange, gain or loss is determined by comparing the cost or other basis of the property given up with the fair market value of the property received. Gain or loss is recognized for both parties.[55]

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[46] 1954 IRC §§ 332-33, 336-37, 351, 354-57, 361, 367-68, 371, 373, 1001-02, 1031-36, 1071, 1081; Proposed Income Tax Regs. (1954), §§ 1.332-1 to -7, 1.333-1 to -5, 1.336-1, 1.337-1 to -5, 1.351-1 to -3, 1.354-1, 1.355-1 to -5, 1.356-1 to -5, 1.357-1 to -2, 1.361-1, 1.367-1, 1.368-1 to -3, 1.371-1 to -2, 1.373-1 to -3.

[47] 1954 IRC § 1031.

[48] See, however, 1954 IRC § 1034. See also *R. A. Farish*, par. 45,056, Prentice-Hall Memorandum T.C. (1945) and *Loughborough Development Corp.*, 29 B.T.A. 95 (1933).

[49] Reg. 111, § 29.112(b)(1)-1; Reg. 118, § 39.112(b)(1)-1.

[50] *Commissioner* v. *Crichton* (5 Cir. 1941), 122 F. 2d 181, 27 AFTR 824; compare *Pembroke* v. *Helvering* (D.C. Cir. 1934) 70 F. 2d 850, 14 AFTR 212.

[51] *W. D. Haden Co.* v. *Commissioner* (5 Cir. 1948), 165 F. 2d 588, 36 AFTR 670.

[52] *Commissioner* v. *North Shore Bus Co., Inc.* (2 Cir. 1944), 143 F. 2d 114, 32 AFTR 931.

[53] *E. R. Braley*, 14 B.T.A. 1153 (1929).

[54] Reg. 111, § 29.112(b)(1)-1; Reg. 118, § 39.112(b)(1)-1.

6. Lease Agreement as an Alternative to a Sale

Consider the following suggested lease arrangements before you make a decision to sell. Understand that they have genuine possibilities, but they do not bear a foolproof guaranty.[56] The tax law applicable to leases of real property likewise generally applies to leases (technically bailments) of personal property.

A long-term lease for a period equal to or longer than the normal depreciable life of the property (building or equipment) may result in a substantial equivalent of a sale. A fair rental would be calculated to return the cost of the equipment plus carrying charges plus a profit. As a result the ordinary income of the owner is spread over the lease term and the lessee is entitled to rental deductions for the amount of the total rental.

Another variation can be a long-term lease with low rentals in the first few years and high rentals thereafter. After holding for over six months, the lessor sells the lease to one investor and the reversion to another. The gain from the sale of the lease would be capital gain, offset by losses for the first six months (or similar period). The lessee would be entitled to rental deductions equaling the cost of the building or equipment, and the purchaser could depreciate his cost over the leased term.

A third alternative is a lease with an option to buy. This arrangement would permit the option holder to take immediate possession of the property, but the tax on the sale would be deferred until the option is exercised. The lessor would depreciate the property and the lessee would depreciate the improvements with, additionally, a deduction for the rental payments. This can be a dangerous transaction, because the rental deduction is possible only when the lessee establishes that the property concerned is property to which he has not taken or is not presently taking title and in which he has no equity.[57] Equitable title is created by delivery of possession if there is an intention to make a sale.

Efforts to disguise sales through the use of the lease form have met with failure where the lease is not bona fide, as in these examples, where the following factors existed:[58]

1. An exact equivalence between the rent and interest on the deferred option price with reductions in the rent to correspond with prepayments of the option price.

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[55] See Table on Sec. 112(b)(1), (2) and (3) exchanges, par. 10,224, 1954 P-H Federal Tax Service, Vol. I.

[56] This summary is based in part on the article by Jenks, "How to Make Effective Use of Installments and Other Sales Mechanics to Reduce Taxes," *Proceedings of New York University Sixth Annual Institute on Federal Taxation*, page 467. New York: Matthew Bender and Company, 1947.

[57] 1954 IRC § 162.

[58] *Helser Machine & Marine Works, Inc.*, 39 B.T.A. 644 (1939); *Jefferson Gas Coal Co. v. Commissioner* (3 Cir. 1931), 52 F. 2d 120, 10 AFTR 396; *Robert A. Taft*, 27 B.T.A. 808 (1933); A. B. *Watson v. Commissioner* (9 Cir. 1932), 62 F. 2d 35, 11 AFTR 1051; *Lodzieske*, par. 44,326 Prentice-Hall Memorandum T.C. (1944); *Alexander W. Smith*, 20 B.T.A. 27 (1930).

2. Agreements for the lessee to pay all fixed charges with successive one-year extensions of the option.

3. Delivery of title when the rents equal the purchase price with credit of the rent on the purchase price.

4. Abnormally large rentals with an option to purchase for a nominal price.

5. Large advance rentals with a nominal option price.

The tax interests of lessor and lessee can, of course, be divergent and some form of compromise must frequently be worked out.[59]

7. Abandonment

Deductions for loss of useful value are not losses caused by a "sale or exchange" within IRC Section 1222 and thus capital loss limitations are not applicable. The opportunity presented to abandon selected property and utilize as a complete loss the adjusted basis of property may be a very useful tax-minimizing vehicle. Realizing salvage through the sale of the abandoned property does not change the result.[60] The distinction between sale and salvage must be carefully applied.[61]

The complete abandonment of property justifies a deduction for the complete loss of value.[62] The abandonment must be a permanent abandonment.[63] The problem here is to determine the identifiable event which sustains the loss of value. Mere shrinkage in value is not sufficient and gradual loss of value is not enough.[64]

The possibility of abandoning property instead of selling it extends to land, even though by the state law the abandonment of title is not recognized.[65] The quitclaiming of property to tax collectors is sufficient evidence of abandonment generally.[66] Full abandonment loss has been allowed if the taxpayer conveyed property to satisfy a tax lien. This holds if the taxpayer is not personally liable for the taxes and receives no other consideration.

The possibility of abandonment in the case of encumbered property must not be overlooked.[67] Generally speaking, the foreclosure of property or the voluntary conveyance by an owner to a mortgagee results in capital loss, whereas abandonment results in ordinary loss. The general rule that an unequivocal abandonment of the property is sufficient, even though there has not been a complete divestment of technical title, applies in these cases. Failure to make further payments on interest or taxes, and actual chargeoff on the books of the taxpayer has been held sufficient, even though the taxpayer disposed of the property for a small sum in a following taxable year.[68]

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[59] See article by Ralph W. Button, "Some Problems of the Retailer: Real Estate Leases; Lifo," *Proceedings of New York University Eleventh Annual Institute on Federal Taxation*, page 259. New York: Matthew Bender and Company, 1953. This article also contains an analysis of the purchase of realty subject to an existing lease, on which see also *Cleveland Allerton Hotel, Inc.* v. *Commissioner* (6 Cir. 1948), 166 F. 2d 805, 36 AFTR 862, reversing par. 47,126 Prentice-Hall Memorandum T.C. (1947).

[60] *Industrial Cotton Mills Company, Inc.*, 43 B.T.A. 107 (1940).

[61] *S. S. White Dental Manufacturing Co.* v. *U.S.* (Ct. Cls. 1944), 55 F. Supp. 117, 32 AFTR 804; cf. *Hygrade Food Products Corp.* v. *Commissioner* (2 Cir. 1944), 144 F. 2d 115, 32 AFTR 1160.

[62] *Reuben H. Donnelly Corp.*, 26 B.T.A. 107 (1932); *Minneapolis, St. Paul and Sault Ste. Marie Railway Co.*, 34 B.T.A. 117 (1936).

[63] See: *Becker* v. *Anheuser-Busch, Inc.* (8 Cir. 1941), 120 F. 2d 403, 27 AFTR 433, cert. den. 314 U.S. 625 (1941). Cf. *Ticket Office Equipment Co., Inc.*, 20 T.C. 272 (1953), affirmed (2 Cir. 1954) 213 F. 2d 318.

[64] Reg. 111, § 29.23(e)-3; Reg. 118, § 39.23(e)-3.

[65] *Denman* v. *Brumback* (6 Cir. 1932), 58 F. 2d 128, 11 AFTR 156.

[66] *Bickerstaff* v. *Commissioner* (5 Cir. 1942), 128 F. 2d 366, 29 AFTR 508.

[67] *Commissioner* v. *Hoffman* (2 Cir. 1941), 117 F. 2d 987, 26 AFTR 486.

If the client is not liable for the mortgage debt, surrender of property to the mortgagee is not a "sale of exchange." [69] If surrender is made for a release of personal liability, a capital loss results.[70] But if your client's (seller's) only personal liability is for accrued taxes, the assumption by the mortgagee of the taxes may be a "sale." [71] If the taxes or other charges are small, the test of personal liability may not be applied.[72] The tests to be applied in the case of abandonment are the same as those applicable to voluntary transfer.

8. Executory Contracts and Other Sales Arrangements

Certain types of property and certain sellers of property may be presented an alternative of tax minimization through sales arrangements that do not follow conventional patterns. These arrangements, unless unquestionable precedent or Treasury ruling is available, must be approached with caution. A few examples are listed for the ingenious practitioner whose client is willing to make full use of the possibilities:

Executory contracts to sell real property can be used to defer the tax effects of a completed sale. Payment of "earnest money" will not result in a sale. But if a purchaser obtains possession, the equitable title resulting may be sufficient "legal" title to constitute a sale for tax purposes.[73]

Similarly, executory contracts can be used to postpone the sale of personal property, with some limitations. Intention to pass title generally controls the sale of goods. If goods are ascertained and in being, an executory contract will pass title, in the absence of an expressed intention. Otherwise, title passes based on the terms of shipping documents. The tax law follows these concepts, and if neither title nor possession is given, the seller is not taxable when a contract of sale is executed.[74] Retention of security title will not deny the sale, however.

An interesting variation is presented where the agreement for the sale provides for a portion of the price to be paid in annual installments, amounts of which are based on the purchaser's sales or profits. If a depreciable asset, such as a patent, is the subject of the sale, it is possible for the seller's gain to be taxed as a capital gain, even though the sales price is not fixed. The buyer may obtain immediate deduction for the annual payments he is required to make. The payments made for the acquisition of such an asset are deductible as a reasonable annual depreciation deduction reflecting the best yardstick for measuring the normal depreciation of the cost of the capital asset.[75]

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[68] *Rhodes* v. *Commissioner* (6 Cir. 1939), 100 F. 2d 966, 22 AFTR 366; cf. *Commissioner* v. *Hoffman* (2 Cir. 1941), 117 F. 2d 987, 26 AFTR 486 and *Commissioner* v. *Abramson* (2 Cir. 1942), 124 F. 2d 416, 28 AFTR 779.

[69] *Polin* v. *Commissioner* (3 Cir. 1940), 114 F. 2d 174, 25 AFTR 598; *Commonwealth, Inc.*, 36 B.T.A. 850 (1937).

[70] *Wieboldt* v. *Commissioner* (7 Cir. 1940), 113 F. 2d 384, 25 AFTR 376; *Day Estate* v. *Commissioner* (7 Cir. 1941), 117 F. 2d 208, 26 AFTR 391.

[71] *Aberle* v. *Commissioner* (3 Cir. 1941), 121 F. 2d 726, 27 AFTR 738.

[72] See: *Stokes* v. *Commissioner* (3 Cir. 1941), 124 F. 2d 335, 28 AFTR 656.

[73] For a full discussion see *Lucas* v. *North Texas Lumber Co.*, 281 U.S. 11, 8 AFTR 10,276 (1930).

[74] *Doyle* v. *Commissioner* (2 Cir. 1940), 110 F. 2d 157, 24 AFTR 471; *Bourne* v. *Commissioner* (4 Cir. 1933), 62 F. 2d 648, 11 AFTR 1346.

Conditional contracts, options, ordinary installment contracts, escrow arrangements, and deferred payment contracts utilizing a non-negotiable note are other possible arrangements which are capable of deferring the time of sale and achieving the desired tax results, if properly used. For example, a deferred payment arrangement with a non-negotiable note results in no income to the seller until the note is actually paid since such a note has no market value. Cash received at the time of sale is first used to offset the basis of the property sold.[76]

A realization that the seller may be one of two or more persons or entities may tip the scales toward a decision to sell.

For example, it was often possible under IRC (1939) Section 113(a)(13) to reduce taxable income to partners, where certain partnership property had appreciated more than other partnership assets. This was done by means of a distribution in kind to the partners of the appreciated property, who then sold the property individually. The resulting tax to them was frequently much lower than would have been the case if the partnership had sold the appreciated property, because Section 113(a)(13) provided that the basis of property distributed in kind was that part of the basis of the distributee's interest in the partnership as was properly allocable to such property.[77] This tax minimizing device is, however, not available to partners under the Internal Revenue Code of 1954, which provides that, as to distributions in kind (other than money and other than in liquidation), the basis in the partners' hands is the same as the adjusted basis to the partnership immediately prior to the distribution.[78]

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[75] *Associated Patentees, Inc.*, par. 43,407 Prentice-Hall Memorandum T.C. (1943); on rehearing, 4 T.C. 979 (1945); acq. 1946-1 C.B. 1; 1954 IRC § 1235.

[76] Footnote 56 above. See also article by Martin Atlas, "Problems in Buying and Selling Real Property." *Proceedings of New York University Tenth Annual Institute on Federal Taxation,* page 57. New York: Matthew Bender and Company, 1952.

[77] See article by Harry Silverson, "Planning for Capital Appreciation," *Proceedings of New York University Fifth Annual Institute on Federal Taxation,* page 628. New York: Matthew Bender and Company, 1946.

[78] 1954 IRC § 732; 83d Cong., 2d Sess., S. Rep. No. 1622 (1954) 390.

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How to Convert Ordinary Income to Capital Gain

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The lower rates at which capital gains are taxed prompts taxpayers to seek means of classifying income as capital gains rather than as ordinary income. Once income is received, of course, its character is fixed. Later events do not bear upon its classification as capital gain or as ordinary income. Strictly speaking, therefore, it is not possible to "convert" one type of income to another. However, it is possible in some instances to shape the determinative factors before the income is received. In the sense that steps may be taken beforehand which will affect the character of income to be received in the future, we may properly speak of converting ordinary income to capital gain.

It must be understood that in most situations where the taxpayer expects to receive ordinary income, it is impossible to change the character of the income. Compensation for personal services, for example, cannot be converted to capital gain. To the extent that a taxpayer receives income in payment of services, such income is classed as ordinary income, and transactions which seek to disguise the nature of such payments have little chance of success.

1. Points to Consider

There are, however, a limited number and kind of instances where, by careful planning, it is possible to convert to capital gain income that would otherwise be classed as ordinary income. It is the purpose of this chapter to indicate how such transactions can be planned and executed. Space limitations necessarily limit this discussion to a few clear-cut situations where the planning indicated will prove successful. Variations and combinations in other situations may also be successful. Taxpayers should check the following list of sections if they expect to receive income of any of the types listed below.

	Section
Trust Income	2
Partnership Income	3
Interest Income	4
Income from a Patent	5
Income from a Corporate Contract	6

The following table points out generally what to do to convert certain kinds of ordinary income to capital gains. For further details and refinements, see the sections indicated.

Source of Ordinary Income	Steps to Take in Order to Convert to Capital Gain
Life estate in a trust	Sale of the life estate. See Section 2
Partnership	Sale of partnership interest. See Section 3
Interest on a loan to a corporation	Lend money at a discount computed under Sec. 1232, I.R.C., and arrange for redemption. See Section 4
Patent royalties	Sale of patent with protective features. See Section 5
Corporate income from contingent contract	Distribute contract to stockholders in liquidation. See Section 6

2. How to Convert Trust Income to Capital Gain

A life beneficiary of a trust whose income is taxed in the upper brackets may obtain substantial reduction in his taxes if he is enabled to sell his life estate for a lump sum payment taxable at capital gains rates.

The possibility of achieving this result is based upon the fact that the life beneficiary has more than a mere right to the income. He has an equitable interest in the trust corpus.[1] That interest or property right may be the subject of capital transactions.

In consummating such a sale of a life estate in a trust it is important to watch for these three factors:

1. The agreement of sale should include all of the beneficiary's right and title in the trust property as well as his right to the income from the property.[2]

2. If the sale is made to a remainderman, the transaction should avoid the form of a mere "surrender" of the life beneficiary's right to income payments. The preferable form is that of a transfer and sale.[3]

3. The total amount received by the life beneficiary on the sale is not necessarily

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[1] *Blair* v. *Commissioner,* 300 U.S. 5 (1937) 18 AFTR 1132.

[2] While the distinction may appear to be academic, the courts have emphasized it. In the *Blair* case, which is the foundation of all of the present law in this field, the Supreme Court held that assignments for life made by a life beneficiary to others shifted the income tax to the assignees. The decision was based on the view that the assignor did not merely assign a right to income, but transferred "an equitable interest in the corpus of the property." See 300 U.S. 5, at 13 (1937). In *Allen* v. *First National Bank & Trust Co.* (5 Cir. 1946), 157 F. 2d 592, cert. denied, 300 U.S. 828 (1947) 35 AFTR 315, which held that capital gain was realized on the sale of a life interest in a trust, the court said: "The question here is whether the taxpayer merely assigned future income or parted with title to the corpus of the estate from which income was expected to be produced." See also, *Bell's Estate* v. *Commissioner* (8 Cir. 1943), 137 F. 2d 454, 457, 458, 31 AFTR 411.

[3] The point was held to be immaterial in *McAllister* v. *Commissioner* (2 Cir. 1946), 157 F. 2d 235, cert. denied, 330 U.S. 826 (1947) 35 AFTR 91. However, it was seriously argued on behalf of the Commissioner, and it would probably be raised again in other courts. Cf. *Hort* v. *Commissioner,* 313 U.S. 28 (1941) AFTR 1207.

taxable. The adjusted cost basis of the life beneficiary's interest must first be determined. In some cases, there will be an allowable capital loss.[4] In other cases, the capital gain will be only a small fraction of the total price received.[5]

The sale of an entire life estate in a trust has been held by several courts to be a capital transaction which produces either a capital gain or a capital loss, and although the Supreme Court has not passed upon the question, it has twice refused to hear cases involving it.[6] Whether something less than the whole interest in a trust life estate may be the subject of a capital transaction has not been directly decided. However, there are some indications in the decisions that such a result is most probable.

The division of a life estate in a trust into lesser interests may be made in two ways: (1) A portion of the income for the life of the primary beneficiary may be assigned, or (2) The entire income for a term of years may be assigned. The first method of division was used in *Blair* v. *Commissioner*[7] in which the life beneficiary made several assignments of his interest to the extent of $9,000 per year of the income which he would be entitled to receive during his life. It was held that there were valid assignments of property interests which shifted the income tax pro tanto to the assignees. Because the *Blair* case is the authority upon which other courts have relied in holding that an entire life estate may be the subject of capital transactions,[8] it would seem to follow that the same kind of lesser interests involved in the *Blair* case could also be sold subject to capital gains rates.[9]

Whether the second kind of lesser interest, the entire income for a term of years, may be similarly treated is a much more difficult question. In two cases decided before the passage of the Revenue Act of 1954, a life beneficiary of a trust who assigned all or a part of the trust income for periods of ten[10] and twelve[11] years was held not taxable on such income. If these cases are not overruled, then sales of such interests by a life beneficiary can be the subject of capital transactions. Moreover, Section 673(a) of the Revenue Act of 1954, which is based on the doctrine of the *Clifford*[12] case does not affect trusts for more than ten years. That section provides that the income of a trust will be taxed to the grantor, if his reversionary interest "will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust." It would seem, therefore, that a sale by the life beneficiary of the right to the entire income for a period of more than 10 years can be the subject of a capital transaction. But a life beneficiary who plans to sell his interest for a term of years should be sure to make the term more than 10 years.

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[4] See *McAllister* v. *Commissioner* in footnote 3.

[5] See *First National Bank & Trust Co.* v. *Allen*, 65 F. Supp. 128 (M.D. Ga., 1946), affirmed (5 Cir. 1946), 157 F. 2d 592, 35 AFTR 315, cert. denied, 330 U.S. 828 (1947). See also, *Bell's Estate* v. *Commissioner* (8 Cir. 1943), 137 F. 2d 454, 31 AFTR 411, in which the case was remanded to the Tax Court to determine the applicable cost basis of the life estates involved. See also, Surrey and Warren, *Federal Income Taxation Cases and Materials*, p. 576. New York: The Foundation Press, 1953.

The purchaser of the life estate, on the other hand, is entitled to amortize the cost of his purchase over the life expectancy of the life tenant, even where the purchaser is also the remainderman. *Bell* v. *Harrison* (D.C. N.D. Ill. 1952), 108 F. Supp. 300, affirmed (7 Cir. 1954) 212 F. 2d 253.

[6] *McAllister* v. *Commissioner*, see footnote 3; *Allen* v. *First National Bank & Trust Co.*, see footnote 2; *Bell's Estate* v. *Commissioner*, see footnote 2. See also, *Randall* v. *Randall*, 60 F. Supp. 308, 313-14 (S.D. Fla. 1944).

[7] See footnote 1.

[8] See cases cited in footnote 6.

[9] Compare *Arthur T. Galt*, 19 T.C. 892 (1953), modified (7 Cir. 1954), 216 F. 2d 41.

[10] *Farkas* v. *Commissioner* (5 Cir. 1948), 170 F. 2d 201.

[11] *Hawaiian Trust Company Ltd.* v. *Kanne* (9 Cir. 1949), 172 F. 2d 74. But see *Estate of Wong Goo Shee* (1948), par. 48,258 Prentice-Hall Memorandum T.C. (1948), holding the assignor taxable on assignments of trust income for periods of 14 months and two years, respectively, and *Marion A. Burt Beck*, 15 T.C. 642, 666 (1950), holding the assignor taxable on assignments of trust income for 5 years. Cf. *Harrison* v. *Schaffner*, 312 U.S. 579 (1941) 25 AFTR 1209.

3. How to Realize Capital Gain on the Sale of a Partnership Interest

The partnership interest of a partner, as distinguished from his interest in the firm's assets, is recognized as a capital asset, and the sale of that partnership interest can produce capital gain.[13] However, Section 751 of the Revenue Act of 1954 limits the portion of the gain upon such a sale which is taxed as capital gain. Any amounts received upon the sale of a partnership interest which are attributable to (a) unrealized receivables of the partnership[14] or to (b) partnership "inventory items" (as defined by the Code) which "have appreciated substantially in value," are taxed as ordinary income. Although this provision severely restricts the opportunity to realize capital gain upon the sale of an interest in a partnership, it is still possible for a partner who wishes to dispose of his interest in the firm or to retire to realize capital gain on at least a portion of the proceeds of such a sale.

"Inventory items" are defined by the Code to include, in addition to ordinary physical inventory, all noncapital assets of the partnership except those depreciable assets used in the trade or business.[15] However, an "inventory item" will not be considered to have appreciated substantially in value unless its fair market value exceeds 120 per cent of its adjusted basis to the partnership *and* 10 per cent of the fair market value of all partnership property, other than money.[16] Thus, if the partnership has on hand a large amount of merchandise inventory, the market value of which is greater than its cost to the partnership but less than 120 per cent of such cost, the selling partner would realize capital gain on the portion of the sales price attributable to that merchandise inventory. On the other hand, if the fair market value of the merchandise inventory exceeds 120 per cent of the cost to the partnership of that inventory, and constitutes 12 per cent of the fair market value of all partnership property other than money, the partnership could sell off merchandise until the value of the inventory remaining was less than the 10 per cent limitation. In this way, a partner who subsequently sold his partnership interest could then realize capital gain on that portion of the sales price attributable to the remaining merchandise inventory.

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[12] *Helvering* v. *Clifford*, 309 U.S. 331 (1940) 24 AFTR 1032.

[13] 1954 IRC § 741. Prior to the enactment of the Revenue Act of 1954, the Bureau in G.C.M. 26379, 1950-1, C.B. 58 had recognized that a partnership interest was a capital asset, thus following the many decisions which had established this principle. See e.g. *Commissioner* v. *Lehman* (2 Cir. 1948), 165 F. 2d 383, 36 AFTR 545, cert. den. 334 U.S. 819 (1948); *Stilgenbaur* v. *United States* (9 Cir. 1940), 115 F. 2d 283, 25 AFTR 966.

[14] This overrules *Swiren* v. *Commissioner* (7 Cir. 1950), 183 F. 2d 656, which held that the profit on a sale of an interest in a law partnership was capital gain, even though the sales price was based in part upon fees billed but uncollected.

[15] 1954 IRC § 751(d)(2).

[16] 1954 IRC § 751(d)(1).

In effecting the sale of a partnership interest to produce capital gain, care must be taken that the agreement of sale specify that the partnership interest is the subject of the sale, rather than the seller's interest in specific assets.[17]

The following are other factors which may play an important part in the sale of a partnership interest:

1. A fraction of a partnership interest is a capital asset too, which may be sold subject to capital gains rates.[18]
2. The holding period of the partnership interest begins at the original date when the taxpayer acquired a partnership interest, and not from the dates specific partnership assets were acquired, nor from the dates of changes in the identity of other partners.[19]
3. The selling partner's distributive share of profits from the end of the partnership's last taxable year to the date of the sale is ordinary income which cannot be converted to capital gain.[20]
4. A partnership interest may be sold to another partner or partners as well as to an outsider.[21]
5. A partner may sell his partnership interest for a price measured by a percentage of future partnership profits for a period of years. For example, a partner who has a one-third interest in profits may sell his partnership interest for a price measured by one-third of the firm's profits for a period of five years following the sale, and still realize capital gain on the sale.[22]

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[17] Otherwise the taxpayer may have to litigate the factual question of what property or property rights were intended to be sold. The intention of the parties as indicated by all of the circumstances determines if there is a sale of a partnership interest or of specific partnership property. *Estate of Hatch* v. *Commissioner* (9 Cir. 1954), 198 F. 2d 26; *Kaiser* v. *Glenn* (1954), (6 Cir. 1954), 216 F. 2d 551; *Ed Krist*, par. 53,247 Prentice-Hall Memorandum T.C. (1953).

[18] *Commissioner* v. *Lehman* (2 Cir. 1948), 165 F. 2d 383, cert. den., 334 U.S. 819 (1948), 36 AFTR 545. 1954 IRC § 751(a) adopts this rule, dealing with the sale of "all or a part" of a partnership interest.

[19] *Commissioner* v. *Lehman* (2 Cir. 1948), 165 F. 2d 383, cert. den., 334 U.S. 819 (1948), 36 AFTR 548; *Thornley* v. *Commissioner* (3 Cir. 1944), 147 F. 2d 416, 33 AFTR 684. See 1954 IRC § 706(c)(1). But Sec. 708(b)(1)(B) provides that a partnership shall be considered as terminated if within a 12 month period there is a sale of 50% or more of the total interest in partnership capital and profits.

[20] *Louis Karsch*, 8 T.C. 1327 (1947); *Robert S. Le Sage* (1947), par. 47,318 Prentice-Hall Memorandum T.C. (1947). This rule is now codified by virtue of § 706(c)(2)(A) of the Revenue Act of 1954 which provides that the taxable year of a partnership shall close with respect to a partner who sells or exchanges his entire interest in a partnership. See Section 706(c)(2)(B) for treatment of undistributed profits where only a portion of a partnership interest is sold.

[21] *Commissioner* v. *Shapiro* (6 Cir. 1942), 125 F. 2d 532, 28 AFTR 1079; *McClellan* v. *Commissioner* (2 Cir. 1941), 117 F. 2d 988, 26 AFTR 487; *U.S.* v. *Landreth* (5 Cir. 1947), 164 F. 2d 340, 36 AFTR 255; *Walter J. Gresham* (1949), par. 49,017 Prentice-Hall Memorandum T.C. (1949); *Robert S. Le Sage* (1947), par. 47,318 Prentice-Hall Memorandum T.C. (1947).

[22] *Hill* v. *Commissioner* (1 Cir. 1930), 38 F. 2d 165; 8 AFTR 10152; see *Helvering* v. *Smith* (2 Cir. 1937), 90 F. 2d 590, 592, 19 AFTR 899. However, such sales made after the effective date of the 1954 act should provide for specific dollar allocations to any unrealized receivables or substantially appreciated "inventory items" in order to insure maximum capital gain treatment. Also see discussion in Section 5.

6. Even if all of the partners sell their interests simultaneously, the sales may still be treated as sales of capital assets.[23]

4. How to Convert Interest Income to Capital Gain

Although the Revenue Act of 1954 has eliminated Section 117(f) of the 1939 Code, which allowed the taxation as capital gain of the profit realized on the retirement of certain corporate bonds issued at a discount, it is still possible, in a much more limited area, to convert interest income to capital gain by the use of corporate securities which are issued at a discount. The particular methods now possible are detailed in subsections entitled, "Rule where original issue discount very small" and "Taking advantage of optional call date provisions," below. A preface is necessary, however, for a clear understanding of these methods.

Old law. A lender who received interest as such on a debt receives ordinary income. Until December 31, 1954, however, a lender could arrange to collect the interest in a different form, as part of the retirement price of corporate securities, thus realizing capital gain. For example, if he wanted to lend $100,000 for one year at five per cent interest, he could insist that the debtor be incorporated, that the debt be evidenced by a registered bond, that the bond be issued at a discount at a price of $95,000, and that the bond be retired at the end of one year at par, $100,000. The lender would thereby be taxable on his gain of $5,000 at capital gains rates. This result was made possible by Section 117(f) of the Internal Revenue Code of 1939, which applies to all registered or coupon bonds issued before December 31, 1954.

Revenue Act of 1954. Section 1232 of the Revenue Act of 1954 has in many respects eliminated the benefits of Section 117(f) of the 1939 Code. Section 1232 provides that amounts received upon the retirement of bonds or other evidences of indebtedness issued by a corporation shall be considered as amounts received in exchange therefor.[24] However, upon the sale or exchange of a bond issued at a discount, that part of the gain which bears the same ratio to the original issue discount[25] as the number of months the bond was held by the taxpayer bears to the number of months from original issue date to maturity date is now taxed as ordinary income.[26] The remainder of the gain upon sale or exchange, if any, is taxed as capital gain. The following examples will illustrate the operation of the new rules:

Example A. Bond issued January 1, 1955; maturity date January 1, 1956; maturity price $100,000; original issue price $95,000. Original issue discount $5,000 ($100,000 – $95,000).

Upon retirement on January 1, 1956, the bond will have been held 12 months.

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[23] Estate of *Hatch* v. *Commissioner* (9 Cir. 1952), 198 F. 2d 26; *Kaiser* v. *Glenn* (1954) Prentice-Hall par. 72,820 (6th Cir. 1954); *Ed Krist*, par 53,247 Prentice-Hall Memorandum T.C. (1953).

[24] The requirement of § 117(f) of the 1939 Code that the bonds either have coupons or be registered has been eliminated by § 1232 of the Revenue Act of 1954.

[25] The term "original issue discount" is defined as "the difference between the issue price and the stated redemption price at maturity." 1954 IRC § 1232(b)(1).

[26] 1954 IRC § 1232(a)(2)(A).

The number of months from original issue date to maturity is 12. The computation is as follows:

$$\$5{,}000 \text{ (original issue discount)} \times \frac{12 \text{ (months bond was held)}}{12 \text{ (months from original issue date to maturity date)}}$$

Thus, $5,000, or all of the original issue discount, would be taxed as ordinary income.

Example B. Bond issued January 1, 1955; maturity date January 1, 1960; maturity price $100,000; original issue price $50,000; original issue discount $50,000 ($100,000 – $50,000). Corporation may call the bond at the end of the first, second, third and fourth years, at $60,000; $70,000; $80,000; and $90,000 respectively.[27] Under Section 117(f) of the 1939 Code, the gain resulting from redemption of such a bond, if registered, at any of the optional call dates, i.e., $10,000, $20,000, $30,000, $40,000 and $50,000, respectively, would have been subject to capital gains rates.[28] The computation under the 1954 Code at each of the optional call dates is:

DATE	REDEMPTION PRICE	TOTAL GAIN	ORDINARY INCOME	CAPITAL GAIN
1/1/56	$ 60,000	$10,000	$\frac{12}{60} \times 50{,}000 = 10{,}000$	—0—
1/1/57	70,000	20,000	$\frac{24}{60} \times 50{,}000 = 20{,}000$	—0—
1/1/58	80,000	30,000	$\frac{36}{60} \times 50{,}000 = 30{,}000$	—0—
1/1/59	90,000	40,000	$\frac{48}{60} \times 50{,}000 = 40{,}000$	—0—
1/1/60	100,000	50,000	$\frac{60}{60} \times 50{,}000 = 50{,}000$	—0—

From these examples, it is seen that if a bond is held to maturity and then redeemed, all of the original issue discount will be taxed as ordinary income. Also, it is clear that redemption on intermediate call dates of the kind of bonds commonly used under former Section 117(f) would now result in ordinary income.

It is still possible, however, to realize a capital gain on the sale of a corporate bond (even if unregistered) before the retirement date, if the bond is sold for a price which exceeds its then appreciated value.

Example C. Bond issued January 1, 1955; maturity date January 1, 1965; maturity price $100,000; original issue price $90,000; original issue discount $10,000 ($100,000 – $90,000).

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[27] The Senate Finance Committee report states that in determining original issue discount, "any price at an optional call date is to be ignored."

[28] *Commissioner* v. *Caulkins* (6 Cir. 1944), 144 F. 2d 482, 32 AFTR 1233. See Charles A. Morehead, "How to Save Taxes in Starting a New Business," *Taxes*, 1948, Vol. 26, pages 555, 563.

(1) Bond sold on January 1, 1960 for \$97,000, a gain of \$7,000. Since original issue discount times $\frac{\text{months held by taxpayer}}{\text{months to maturity}}$ is $\$10{,}000 \times \frac{60}{120}$, or \$5,000, only \$5,000 of the gain is ordinary income. The balance of \$2,000 would be capital gain.

(2) If the same bond is purchased for \$80,000, on January 1, 1960, by a second holder who keeps it to redemption, to the extent of \$15,000 of his \$20,000 gain, the computation is similar: ($\$10{,}000 \times \frac{60 \text{ months}}{120 \text{ months}} = \$5{,}000$, the portion of the gain taxable as ordinary income).

Rule where original issue discount very small. The Revenue Act of 1954, however, specifically allows conversion of interest income to capital gain where the original issue discount is less than a specified percentage. In addition, it is no longer necessary for the bond to be registered. Any corporate bond qualifies.

"If the original issue discount is less than one-fourth of one per cent of the redemption price at maturity multiplied by the number of complete years to maturity, then the original issue discount shall be considered to be zero." (§ 1232 (b)(1)). In such case all of the gain attributable to the original issue discount will receive capital gain treatment.

For example, if a \$100,000 ten year bond is initially sold at \$98,000, the original issue discount is \$2,000. Since one-fourth of 1 per cent (.25 per cent) of the maturity price (\$250) multiplied by 10, the number of years to maturity, is \$2,500, or a figure greater than the original issue discount, the \$2,000 gain upon retirement of the bond would be taxable as capital gain. Moreover, the bond could provide for retirement before maturity at the option of the corporation for the full maturity price. Such prepayment privilege would not affect the capital gain treatment.

Taking advantage of optional call date provisions. Section 1232 of the Revenue Act of 1954 was directed, in part, at bonds with steadily increasing retirement prices, such as that in Example B above. Prior to its enactment, the gain at any retirement date was capital gain, if the bond was registered. However, as was stated in Example B, Section 1232 taxes as ordinary income all of the gain, at each of the retirement dates.

Nevertheless, it still seems possible to convert interest income to capital gain by the use of a bond with *disproportionately increasing retirement prices.* For example, a lender may pay \$75,000 for a bond redeemable at the end of five years at a price of \$100,000, the borrower having the option to redeem the bond for \$85,000 at the end of the first year, \$90,000 at the end of the second year, \$95,000 at the end of the third year, and \$97,500 at the end of the fourth year.[29] The original issue discount is \$25,000, the price at maturity less the amount paid by the first purchaser. The portions of the gain taxable as ordinary income and the portions taxable as capital gain, at each optional call date, would be as follows:

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[29] The most common example of a bond with disproportionately increasing retirement prices is the United States Savings Bond, Series E. However, Section 1232 and the following analysis are inapplicable to such bonds, since 31 USC § 757(c)(d) specifically provides that "for purposes of taxation any increment in value represented by the difference between the price paid and the redemption value received (whether at or before maturity) for savings bonds and savings certificates shall be considered as interest."

End of Year	Redemption Price	Total Gain	Ordinary Income	Capital Gain
1	85,000	10,000	5,000 $\left(\frac{12}{60} \times 25{,}000\right)$	5,000
2	90,000	15,000	10,000 $\left(\frac{24}{60} \times 25{,}000\right)$	5,000
3	95,000	20,000	15,000 $\left(\frac{36}{60} \times 25{,}000\right)$	5,000
4	97,500	22,500	20,000 $\left(\frac{48}{60} \times 25{,}000\right)$	2,500
5	100,000	25,000	25,000 $\left(\frac{60}{60} \times 25{,}000\right)$	—0—

Thus, if the corporation prospered, it might be in a position to redeem the bond at the end of the 1st, 2nd, 3rd or 4th year, resulting in some capital gain to the lender, at each of these optional call dates. In this way, the lender would be converting part of the interest income to capital gain. Moreover, the bond could provide for an interest rate, in addition, without affecting the nature of the gain upon retirement at any of the optional call dates.[30] Accrued interest, however, if paid, would be taxable as ordinary income.

It is still possible, therefore, to convert interest income to capital gain by the use of corporate discount bonds, under either of the following conditions:

a. The original issue discount is less than ¼ of 1 per cent of the maturity price multiplied by the number of years to maturity;

b. The bond is issued at a discount and provides for optional retirement at the end of each year at disproportionately increasing retirement prices.

It should be noted that the result in (b) was probably not contemplated by the draftsmen of Section 1232. It was considered that this Section closed the loophole left by Section 117(f). Another loophole, however, seems to have been left by Section 1232.

5. How to Realize Capital Gains from Patents

Royalty income from the license of a patent is ordinary income,[31] but income realized on the sale of a patent which is a capital asset is capital gain.[32] If the owner of such a patent can arrange a sale, therefore, rather than licenses, he will have the advantage of the capital gains tax rates. From a business standpoint, however, a patent owner may prefer licensing to an ordinary outright sale. License agreements give him control over such matters as market development and prices, and insure that as the patent increases in value, his royalty income will increase. But sales may be arranged on terms which will give the seller a large measure of protection in such matters and still give him the advantage of a capital gain.

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[30] In view of a recent Tax Court decision, *F. Rodney Paine*, 23 T.C. No. 48 (1954), it would be advisable for any bond issued at a discount to be interest bearing. In the *Paine* case, it was held that the gain upon sale before maturity, of an unregistered, non-interest bearing bond issued at a discount was taxable as ordinary income, on the ground that the discount represented interest.

[31] See, for example, *The Cleveland Graphite Bronze Co.* 10 T.C. 974 (1948).

[32] See, for example, *Commissioner* v. *Hopkinson* (2 Cir. 1942), 126 F. 2d 406, 28 AFTR 1349.

1. Patents as capital assets.

a. Patent held by inventor. A patent held by an inventor is now treated as a capital asset, regardless of whether or not the inventor holds the patent primarily for sale to customers. The distinction between "professional" inventors and "amateur" inventors has been removed by section 1235 of the Revenue Act of 1954. So long as the sale of the patent is made by the inventor to others than certain related parties, it will be treated as the sale of a capital asset. And the gain or loss on such sale will be taxed as long-term capital gain or long-term capital loss, even if the patent was held for less than six months.

b. Patent held by someone other than inventor. A patent held by someone other than the inventor may or may not be a capital asset, depending on the usual tests for determining capital assets. Even if it is not a capital asset, it still may be possible to sell a patent at capital gain rates if it is depreciable property used in the taxpayer's business, under section 1231 of the Revenue Act of 1954.[33] Only when it is held "primarily for sale to customers in the ordinary course" of business, will the patent owner be required to pay ordinary rates on the gain from a sale. Whether a patent is held for that purpose is a factual question subject to the same kinds of tests applied to other property.[34] Previous licensing agreements involving a patent are a favorable factor tending to show it has not been held primarily for sale.[35]

2. Sales of patents. In order to constitute a sale of a patent, a transaction must effectively transfer the right to make, the right to use, and the right to sell. An agreement transferring the rights to make and sell, but omitting mention of the right to use, constitutes a license, and not a sale of the patent.[36] Similarly, a sale will not be effectuated if title is expressly reserved in the taxpayer, even though all of these rights are specifically transferred.[37]

a. Sale of a patent for contingent consideration. Section 1235(a) of the Revenue Act of 1954, specifically provides that an inventor may sell a patent for payments "payable periodically over a period generally coterminous with the transferee's use of the patent" or "contingent on the productivity, use, or disposition of the property transferred" and still realize a capital gain on the sale. This section merely codifies the results reached under the 1939 Code, for it has been recognized that any patent owner may stipulate a price usually associated with royalties, and still realize a capital gain. A contingent sales price does not destroy the effectiveness of a sale if the parties clearly provide for the passage of title. For example, a patent may be sold for a consideration of a percentage of the gross revenues earned by the buyer.[38] Or the price may be measured by the number of units produced by the buyer, or by the savings to the buyer in production costs resulting from the use of the patent.[39] In the event of a resale by the buyer, the seller may obtain a larger percentage of the buyer's profit or of the gross resale price.[40] When the terms of sale are cast in this fashion, the patent owner is able to realize capital gain while receiving income on a "royalty" basis. The seller pays no tax until he has recouped his cost basis, and thereafter the income is reportable as capital gain.[41]

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[33] See *Raymond M. Hessert*, par. 47,301 Prentice-Hall Memorandum T.C. (1947). Section 1231 is virtually identical with Section 117(j) of the 1939 Act.

[34] See Brodsky, "How to Convert Ordinary Assets to Capital Assets," *Proceedings of New York University Thirteenth Annual Institute on Federal Taxation*, page 1173. New York: Matthew Bender and Company, 1955.

[35] See *Lester P. Barlow*, par. 43,237 Prentice-Hall Memorandum T.C. (1943); *John W. Hogg*, par. 44,066 Prentice-Hall Memorandum T.C. (1944); *Samuel E. Diescher*, 36 B.T.A. 732 (1937). See also *W. J. Casey*, "Sale of Patents, Copyrights and Royalty Interest," *Proceedings of New York University Seventh Annual Institute on Federal Taxation*, page 383. New York: Matthew Bender and Company, 1949.

[36] *The Cleveland Graphite Bronze Co.* 10 T.C. 974 (1948); see *Edward C. Myers*, 6 T.C. 258, 263 (1946); *Kimble Glass Co.*, 9 T.C. 183 (1947).

[37] *Federal Laboratories, Inc.*, 8 T.C. 1150 (1947).

The Treasury, in Mim. 6490 (1950-1CB9), attempted to tax the gain as ordinary income where the sales price is "measured by production, sale or use," or where it is payable "periodically over a period generally coterminous with the transferee's use of the patent." However, the Courts have pretty much ignored this ruling, and have continued to hold after its issuance, as they did before, that sales for prices measured by percentage of sales may still result in capital gains.[42] Furthermore, the Senate Finance Committee Report on the Revenue Act of 1954 makes it clear that with respect to sales by inventors, Mim. 6490 is specifically overruled. In view of the prior contrary court decisions, and § 1235(a) of the Revenue Act of 1954, it is doubtful whether this ruling retains any validity even as applied to sales of patents by non-inventors.

b. Sales for contingent consideration with protective features for the seller. When a patent is sold for a consideration of a percentage of the buyer's gross revenue or profits, or production, the seller is dependent upon the ability of the buyer to exploit the patent successfully. The seller may later feel that the buyer is using poor methods in marketing, or that the license agreements made by the buyer are not advantageous. Yet, the seller's consideration depends upon the revenues thus obtained, which may prove to be quite meager. Or, it may happen that the buyer will run into financial difficulties, and go bankrupt. How can the seller protect himself, in the original transaction, against such eventualities? If protective measures are taken, will they transform the transaction from a sale into a license? There are a good many protective features which can be included in the original sales contract which the courts have approved as being consistent with a sale of the patent. Some of these features for which the seller of a patent for a contingent consideration may provide are the following:

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[38] *Leo P. Curtin*, par. 47,115 Prentice-Hall Memorandum T.C. (1947); *Raymond M. Hessert*, par. 47,301 Prentice-Hall Memorandum T.C. (1947); *Kimble Glass Co.*, 9 T.C. 183 (1947); *William M. Kelly*, par. 47,252 Prentice-Hall Memorandum T.C. (1947); *Commissioner* v. *Hopkinson* (2 Cir. 1942), 126 F. 2d 406; *Elrod Slug Casting Machine Co.*, par. 48,041 Prentice-Hall Memorandum T.C. (1948); *Edward C. Myers*, 6 T.C. 258 (1946); *Carl G. Dreymann*, 11 T.C. 153 (1948), *Allen* v. *Werner* (5 Cir. 1951), 190 F. 2d 840; *Kronner* v. *U.S.* (Ct. Cls. 1953), 110 F. Supp. 730. But cf. *Block* v. *U.S.* (2 Cir. 1952), 200 F. 2d 63.

[39] See *Commissioner* v. *Hopkinson* (2 Cir. 1942), 126 F. 2d 406, 28 AFTR 1349; *Kimble Glass Co.*, 9 T.C. 183 (1947).

[40] *Leo P. Curtin*, par. 47,115 Prentice-Hall Memorandum T.C. (1947); *Elrod Slug Casting Machine Co.*, par. 48,041 Prentice-Hall Memorandum T.C. (1948).

[41] *Commissioner* v. *Hopkinson* (2 Cir. 1942), 126 F. 2d 406, 28 AFTR 1349.

[42] See for example, *Arthur C. Cope*, par. 53,488 Prentice-Hall Memorandum T.C. (1953); *Carruthers* v. *U.S.*, (D.C.D. Ore. 1953) par. 72,427 Prentice-Hall (1953); *Allen* v. *Werner* (5 Cir. 1951), 190 F. 2d 840; *Massey* v. *U.S.* (D.C. N.D. Ill. 1954), par. 72,829 Prentice-Hall (1954).

1. If the buyer goes bankrupt, the title to the patent is to revert to the seller.[43]
2. If payments to the seller fall below a certain amount in a given period, the seller may terminate the contract and retake title.[44]
3. The buyer may be given the right to terminate the contract on notice to the seller.[45]
4. In case of breach of the contract by the buyer, the seller may terminate the contract and retake title.[46]
5. The seller may retain some control over the terms of resale by the buyer.[47]
6. The seller may retain some control over the terms of licensing agreements to be made by the buyer.[48]

6. How to Realize Capital Gain through Distribution of Corporate Contracts in Liquidation

A corporation that has a contingent contract under which it earns periodic ordinary income may in some circumstances liquidate and distribute the contract to its stockholders, with the result that the stockholders will receive capital gain income from later payments on the contract. For example, a corporation may have a patent royalty contract under which it receives a percentage of the licensee's profits. The corporation would receive ordinary income from this contract. If the corporation is liquidated, and the contract is distributed to the stockholders, then the contract is treated as "in exchange for the stock" of the stockholders.[49] The stockholders' gains on liquidation would be computed by valuing all of the property, including the contract, received by them in liquidation. However, the value of the contract depends upon future, contingent profits of the licensee, and in these circumstances it would have no ascertainable fair market value.[50] Therefore, the tax on the gain to the stockholders represented by the value of the contract would be postponed until payments on the contract are received by the stockholders. Such payments, after the stockholders recoup the cost basis of their stock, will be taxable at capital gains rates.[51]

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[43] *Commissioner* v. *Celanese Corp. of America* (D.C. Cir. 1944), 140 F. 2d 339, 32 AFTR 42; *Carl G. Dreymann*, 11 T.C. 153 (1948); *Raymond M. Hessert*, par. 47,301 Prentice-Hall Memorandum T.C. (1947).

[44] *Edward C. Myers*, 6 T.C. 258 (1946); *William M. Kelly*, par. 47,252 Prentice-Hall Memorandum T.C. (1947); *Raymond M. Hessert*, par. 47,301 Prentice-Hall Memorandum T.C. (1947).

[45] *Kimble Glass Co.*, 9 T.C. 183 (1947); *Edward C. Myers*, 6 T.C. 258 (1946); *Allen* v. *Werner*, 190 F. 2d 840 (5 Cir. 1951).

[46] *William M. Kelly*, par. 47,252 Prentice-Hall Memorandum T.C. (1947); *Raymond M. Hessert*, par. 47,301 Prentice-Hall Memorandum T.C. (1947); *Carl G. Dreymann*, 11 T.C. 153 (1948); *Lester P. Barlow*, par. 43,237 Prentice-Hall Memorandum T.C. (1943).

[47] *Elrod Slug Casting Machine Co.*, par. 48,041 Prentice-Hall Memorandum T.C. (1948); *Leo P. Curtin*, par. 47,115 Prentice-Hall Memorandum T.C. (1947); *Carl G. Dreymann*, 11 T.C. 153 (1948).

[48] *Carl G. Dreymann*, 11 T.C. 153 (1948).

[49] 1954 IRC § 302(a); 1939 IRC § 115(c).

[50] *Burnet* v. *Logan*, 283 U.S. 404 (1931), 9 AFTR 1453; *Commissioner* v. *R. J. Darnell, Inc.* (6 Cir. 1932), 60 F. 2d 82, 11 AFTR 711.

The success of this kind of transaction depends upon two essential elements: (1) A contract whereby the corporation is to receive future contingent and uncertain payments, and (2) distribution of the contract to the stockholders in complete liquidation of the corporation. If the contract does not call for future contingent and uncertain payments or if the contingencies are such that the contract has an ascertainable fair market value, then the stockholders' gain can be computed at the time of liquidation. While their gain will then be capital gain just as in the case of any other liquidation, the tax will be payable at that time, before further payments are received by the stockholders, and will not be deferred until the time payments are actually received.

There are two other points that must be watched in carrying out a transaction of this kind:

1. If any payments are actually due, though unpaid, to the corporation at the time of the liquidation, or if, because of the occurrence of certain contingencies, the payments may be considered as already "earned" by the corporation, those payments will be allocated to the corporation even though the stockholders receive them after liquidation.[52]
2. If the stockholders, after receiving the contract in liquidation, are required by the terms of the contract to cause any personal services to be rendered to the other party to the contract, then future payments to the stockholders may be considered as payments for such services and therefore ordinary income.[53]

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[51] *Commissioner* v. *Carter* (2 Cir. 1948), 170 F. 2d 911; *Westover* v. *Smith*, 173 F. 2d 90 (9 Cir. 1949).

[52] See *Jud Plumbing & Heating, Inc.* v. *Commissioner* (5 Cir. 1946), 153 F. 2d 681, 34 AFTR 1025; *Guy M. Shelley*, 2 T.C. 62 (1943); cf. *Essex Construction Co.*, 12 T.C. No. 163 (1949); *Standard Paving Co.*, 13 T.C. No. 60 (1949), affirmed (10th Cir. 1951) 190 F. 2d 330.

[53] See *Susan J. Carter*, 9 T.C. 364 (1947), affirmed (2 Cir. 1948) 170 F. 2d 911.

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How to Defer the Sale to Another Period

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When an owner decides to dispose of property, it becomes important to avoid an undue tax burden in any one year as a result of receiving the proceeds. There are many ways of spreading or postponing tax liabilities. The relative advantages and disadvantages of various methods are treated in this chapter.

1. Points to Consider

The preliminary questions to consider are the following:

	Section
When does the "sale" occur?	2
Should the property be exchanged, rather than sold?	3
Will an option to buy be preferable?	4
Will a lease accomplish the same result?	5

If an outright sale is required by the circumstances, you should then weigh the following choices:

	Section
Executory contract of sale	2
Installment sale	6
Deferred payment sale	7

Your choice of deferment methods will depend on the answers to these questions:

	Section
Is the property real or personal?	2, 6
Do you have a loss on the property to be sold?	3, 6, 7
Does the property constitute a capital asset?	6, 7
Do you need to extend the holding period?	2, 3, 4
Will the down payment exceed 30 per cent of total selling price?	6, 7
Will the deferred payments consist of cash, notes, or other property?	6, 7
Will the property received as deferred payment have a fair market value?	7
Are there any contingencies attached to the deferred payments?	7

The tax results will vary, according to the answers to the above questions. Frequently, you may create the result you want by setting the terms of the sale. Re member that the seller controls the terms of sale and that the form he selects is vital to the tax problem.

2. When Does the Sale Occur?

No profit or loss is recognized for tax purposes until a sale occurs.[1] "Sale" is an elusive term. The tax definition is based on legal concepts relating to real and personal property.[2]

The general rule for *real* property is that the sale occurs when *either* title or possession is delivered to the purchaser following a binding contract of sale.[3] The rule for *personal* property is that the sale occurs when the parties intend that title to the goods shall pass to the purchaser.[4] *Mixed* property (for example sale of a business) generally follows the rule for realty.[5]

An executory contract to sell either real or personal property does not constitute a sale, even though accompanied by a down payment,[6] *except* that specific ascertained *personal* property (for example, shares of corporate stock) is sold when a binding contract to sell is made.[7]

The following tabulation may be helpful in determining the moment of sale for tax purposes:

Type of Property	*Terms of Sale*	*When Sale Occurs*
Realty	Contract of sale, down payment, delivery of deed against purchase money on settlement day	Settlement day

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[1] *Lucas* v. *North Texas L. Co.*, 281 U.S. 11, 8 AFTR 10276 (1930); *J. T. Wurtsbaugh*, 8 T.C. 183 (1947).

[2] See, generally, Jacob Mertens, *Law of Federal Income Taxation*, Chicago, Callaghan and Company, 1942, § 12.119 and following; § 12.125 and following; Uniform Sales Act.

[3] *Frost Lumber Industries* v. *Commissioner* (5 Cir. 1942), 128 F. 2d 693, 29 AFTR 692; *Henrietta S. Carter, Executrix*, 18 B.T.A. 853 (1930); *Old Farmers' Oil Co.*, 12 B.T.A. 203 (1928); *J. Presper Eckert*, par. 52,132 Prentice-Hall Memorandum T.C. (1952); *Elsinore Cattle Co.*, par. 50,041 Prentice-Hall Memorandum T.C. (1950); cf. *North Carolina Lumber Co.*, 19 T.C. #74 (1953). It is probably immaterial whether the taxpayer is on the cash or accrual basis. *Lucas* v. *North Texas L. Co.*, footnote 1, above; but see *Helvering* v. *Nibley-Mimnaugh Lumber Co.* (D.C. Cir. 1934), 70 F. 2d 843, 14 AFTR 209; *Evergreen Cemetery Assn.* v. *Burnet* (D.C. Cir. 1930), 45 F. 2d 667, 9 AFTR 675. A contingency only as to time of payment does not postpone the sale. *Wisconsin Electric Power Co.*, 18 T.C. 400 (1952).

[4] *Commissioner* v. *East Coast Oil Co.* (5 Cir. 1936), 85 F. 2d 322, 18 AFTR 446, cert. den. 299 U.S. 608 (1936); *Ronrico Corporation*, 44 B.T.A. 1130 (1941); *Ohio Brass Co.*, 17 B.T.A. 1199 (1929); *J. D. Amend*, 13 T.C. 178 (1949). As with real estate (cf. *Wisconsin Electric Power Co.*, footnote 3, above), contingency only as to time of payment does not postpone the sale. *Alexander H. Kerr & Co.* v. *United States*, 97 F. Supp. 796, 40 AFTR 898 (S.D. Calif., 1951).

[5] *Commissioner* v. *Segall* (6 Cir. 1940), 114 F. 2d 706, 25 AFTR 698, cert. den. 313 U.S. 562 (1941); *Helvering* v. *Nibley-Mimnaugh Lumber Co.*, footnote 3, above; *Evansville Oil Corp.*, par. 53,016, Prentice-Hall Memorandum T.C. (1953).

[6] *Lucas* v. *North Texas L. Co.*, footnote 1, above; *Doyle* v. *Commissioner* (2 Cir. 1940), 110 F. 2d 157, 24 AFTR 471; *Bourne* v. *Commissioner* (4 Cir. 1933), 62 F. 2d 648, 11 AFTR 1346; *Bedell* v. *Commissioner* (2 Cir. 1929), 30 F. 2d 622, 7 AFTR 8469.

[7] *Ruml* v. *Commissioner* (2 Cir. 1936), 83 F. 2d 257, 17 AFTR 958; *Hoffman* v. *Commissioner* (2 Cir. 1934), 71 F. 2d 929, 14 AFTR 331; C. R. *Dashiell*, 36 B.T.A. 313 (1937), affirmed (7 Cir. 1938) 100 F. 2d 625, 22 AFTR 163; *Dee Furey Mott*, 35 B.T.A. 195 (1936); see *Harden F. Taylor*, 43 B.T.A. 563 (1941), affirmed on other grounds (2 Cir. 1942) 128 F. 2d 885, 29 AFTR 741.

Type of Property	*Terms of Sale*	*When Sale Occurs*
Same	Contract of sale, immediate possession, deed escrowed against payment of all notes	When possession delivered
Same	Contract of sale, immediate delivery of deed, possession retained until first payment	When deed is delivered
Manufactured Goods	F.O.B. factory, or C.I.F. factory	When goods are delivered to common carrier
Same	F.O.B. destination point. or C.O.D., or Delivery in seller's equipment, or Consignment to seller's agent	When goods are delivered to purchaser
Securities (specifically identified)	Contract to sell, delivery at later date	When contract executed
Same	Short sale	When securities are delivered to cover[8]

Practical use can be made of these rules for "timing" sales. If you wish to postpone tax on a gain temporarily, enter into an executory contract and obtain a substantial down payment this year; deliver the property or fix the settlement day next year. If you desire to accelerate a loss on real property, deliver title or possession immediately. If you wish to obtain an immediate loss on securities not physically available, make a binding contract to sell them, either personally or through a broker.[9]

3. Should the Property Be Exchanged Rather Than Sold?

Often an exchange of property is preferable to a sale. If the exchange is tax-free, there is no gain or loss until the property received in exchange is sold.

An exchange is tax-free if it meets the following requirements:[10]

1. Both the property given up and the property received must be held "for productive use in trade or business or for investment." *Not* included: Securities, stock in trade, property held primarily for sale.[11] But, inventories of raw materials and work in process probably qualify as property held for productive use.[12]

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[8] Manipulation of short sales to create long-term capital gains out of essentially short-term situations is prevented by 1954 IRC § 1233(b), (d) and (e); 1939 IRC § 117(l). These provisions qualify the general rules where the taxpayer holds substantially identical property prior to the short sale. See, also, Mim. 6243, 1948-1 Cum. Bull. 44, with regard to commodity short sales.

[9] See footnote 7, above.

[10] 1954 IRC § 1031(a); 1939 IRC § 112(b)(1).

[11] Ibid. It is frequently difficult to distinguish between property held "for investment" and property held "primarily for sale." See, *Loughborough Development Corp.*, 29 B.T.A. 95 (1933); R. A. Farish, par. 45,056 Prentice-Hall Memorandum T.C. (1945).

[12] Compare 1954 IRC § 1221(1); 1939 IRC § 117(a)(1), which adds to the words "stock in trade" the following: "or other property of a kind which would properly be included in inventory of the taxpayer if on hand at the close of the taxable year." The inference is that "stock in trade" is limited to inventories of finished or salable articles.

2. The property given up and the property received must be of "like kind." "Like kind" means like in "character," not like in "quality." [13] Urban and rural real estate may be exchanged, e.g., a farm for a building.[14] But realty may not be exchanged for personality.[15] A long-term lease (i.e., over 30 years) may be exchanged for a fee interest.[16] The producing interest in an oil lease may be exchanged for a farm[17] but not for a royalty or other non-working interest.[18]

If the exchange is tax-free, the cost of the property given up is transferred to the property received, for purposes of measuring the gain or loss on subsequent sale.[19] Cash *paid* on the exchange is added to your basis for the property received.[20] Cash *received* on the exchange is taxable to you to the extent of your gain on the property given up.[21]

Some practical applications of the foregoing:

An exchange cannot be used by a dealer in real estate or personal property to postpone tax on his ordinary business sales.[22]

Residential properties may be exchanged, under a special statutory provision[23] even though not "held for investment."

An exchange is not desirable if property is held at a loss, since the loss will be postponed.[24]

An exchange may be very desirable on a fully depreciated machine, or a business automobile, if a new one will be purchased. A "trade-in" will avoid immediate tax.[25] But keep in mind that there will be no increase in basis for depreciation. It may be cheaper to pay a 25 per cent tax on sale, and take advantage of depreciation on the new purchase price.

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[13] Reg. 118, § 39.112(b)(1)-1. Interpretations of 1954 IRC § 1031(a); 1939 IRC § 112(b)(1) are far broader than those under 1954 IRC § 1033; 1939 IRC § 112(f), which deals with involuntary conversions and *replacement* by property similar or related in service.

[14] *E. R. Braley*, 14 B.T.A. 1153 (1929).

[15] *Oregon Lumber Co.*, 20 T.C. #23 (1953).

[16] Reg. 118, § 39.112(b)(1)-1. This result seems inconsistent with the rule that realty and personalty may not be exchanged, since a lease is a chattel real, normally regarded as personalty. But the cases have supported this regulation, even where the exchange of fee and leasehold is in the same property (popularly known as a "sale-and-leaseback"), *Century Electric Co.* v. *Commissioner* (8 Cir. 1951), 192 F. 2d 155, 41 AFTR 205, cert. den. 342 U.S. 954 (1952); *May Department Stores, Inc.*, 16 T.C. 547 (1951); cf. *Pembroke* v. *Helvering* (D.C. Cir. 1934), 70 F. 2d 850, 14 AFTR 212.

[17] I.T. 4093, 1952-2 Cum. Bull. 130. A personal residence, equipment and livestock of the ranch property were excepted from the non-recognition provision.

[18] *Bandini Petroleum Co.*, par. 51,310, Prentice-Hall Memorandum T.C. (1951). But see *Fleming* v. *Campbell* (5 Cir. June 26, 1953), 205 F. 2d 549 (involving transfer of a fee interest for an oil payment). The conclusion stated in the text has also been reached where an oil payment was exchanged for an overriding royalty. *Midfield Oil Co.*, 39 B.T.A. 1154 (1939); *Kay Kimbell*, 41 B.T.A. 940 (1940). Since these are both "non-working" interests, the decision that they are not of "like kind" is difficult to justify logically.

[19] 1954 IRC § 1031(d); 1939 IRC § 113(a)(6).

[20] 1954 IRC § 1016(b); 1939 IRC § 113(b)(2).

[21] 1954 IRC § 1031(b); 1939 IRC § 112(c)(1); *George E. Hamilton*, 30 B.T.A. 160 (1934).

[22] *Loughborough Development Corp.*; R. A. Farish, footnote 11, above.

[23] 1954 IRC § 1034; 1939 IRC § 112(n). The prior law, interpreting 1939 Code § 112(b)(1) was to the contrary. I.T. 1587, II-1 Cum. Bull. 26 (1923).

[24] *Burkhard Inv. Co.* v. *United States* (9 Cir. 1938), 100 F. 2d 642, 22 AFTR 172; *Century Electric Co.*, footnote 16, above.

[25] *Commissioner* v. *North Shore Bus Co., Inc.* (2 Cir. 1944), 143 F. 2d 114, 32 AFTR 931; *W. H. Hartman Co.*, 20 B.T.A. 302 (1930); I.T. 2356, VI-1 Cum. Bull. 168 (1927); Cf. *Joseph J. Vidmar*, par. 52,248, Prentice-Hall Memorandum T.C. (1952).

An exchange may be useful to extend a holding period, since the holding period of the property received will be "tacked" to the holding period of the property given up. However, "tacking" is permitted by the 1954 Code (on exchanges made after March 1, 1954) only if the property exchanged was either a capital asset in the hands of the taxpayer or property used in the taxpayer's trade or business as defined in sections 1221 and 1231 respectively.[26]

4. Will an Option to Buy Be Preferable?

An option differs from a sale in that the purchaser is not firmly bound until he exercises the option. But this difference may be illusory, if the option payment is substantial and forfeitable upon non-exercise. Then it serves the same function as a down payment on an executory contract.

A *forfeitable* option payment has no tax consequences until expiration of the option period.[27] At that time, it constitutes ordinary income to the vendor if forfeited;[28] if exercised, it becomes a part of the sale proceeds for measuring gain or loss.[29] A *returnable* option payment is a deposit for security purposes, and is not taxable when received or returned.[30] If the option contract is *silent* as to the disposition of the option payment at the end of the option period, it probably constitutes immediate ordinary income to the vendor.[31] Be sure, therefore, that the option contract provides expressly for the forfeiture or return of the option money.

An option may be used effectively to extend the holding period of an asset, thus converting a short-term capital gain into a long-term gain. Theoretically, the same result should be accomplished by an executory contract of sale, with title and possession retained. But the option method avoids the difficulties of determining when the actual "sale" occurred, particularly in the case of security transactions.

5. Will a Lease Accomplish the Same Result?

Suppose the optionee wants to take possession of the property during the period of the option. This arrangement constitutes a lease of the property, with an option to buy attached.

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[26] 1954 IRC § 1223(1); 1939 IRC § 117(h)(1).

[27] *Virginia Iron Coal & Coke Co.* v. *Commissioner* (4 Cir. 1938), 99 F. 2d 919, 21 AFTR 1221.

[28] The Committee Reports state that under 1954 IRC § 1234 the grantor of an option always will realize ordinary income on the failure to exercise any option; under 1939 IRC § 117(g)(2) the grantor realized short-term capital gain.

[29] *Aiken* v. *Commissioner* (8 Cir. 1929), 35 F. 2d 620, 8 AFTR 9749.

[30] *Clinton Hotel Realty Corp.* v. *Commissioner* (5 Cir. 1942), 128 F. 2d 968, 29 AFTR 758; *Veenstra & DeHaan Coal Co.*, 11 T.C. 964 (1948); cf. *Woodland Park Cemetery Co.*, 16 T.C. 1067 (1951).

[31] *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 11 AFTR 16 (1932); *Estelle Pardee Erdman*, 1946, par. 46,038 Prentice-Hall Memorandum T.C.; see *Hirsch Improvement Co.* v. *Commissioner* (2 Cir. 1944), 143 F. 2d 912, 32 AFTR 1104; *Gilken Corporation*, 10 T.C. 445 (1948), affirmed (6 Cir. 1949) 176 F. 2d 141, 38 AFTR 265; *Est. of Mary R. Gordon*, 17 T.C. 427 (1951), affirmed (6 Cir. 1952) 201 F. 2d 171, 43 AFTR 144.

Advantages of the lease form, to lessor and lessee, are as follows:

Lessor	*Lessee*
No tax until option exercised	Deduction for rentals
Rental payments spread over term	Deduction for depreciation of improvements over lease term
Offsetting depreciation deductions	

This arrangement, however, involves considerable risk that the transaction may be classified as a sale despite the lease form.[32] Substance governs, not form.[33] The ultimate question is one of the intention of the parties to the transaction at the time it is entered into.[34] Avoid any of the following incidents, which, in the absence of compelling contrary factors, may be found to indicate intent to make a sale, not a lease:

Specific application of all or a portion of the periodic payments to the purchase price of the property.[35]

Acquisition of title by lessee without additional cost upon completion of periodic payments.[36]

Payments for short period of use excessive in relation to sum required to be paid to acquire title.[37]

Rental payments substantially in excess of current fair rental value.[38]

Nominal option price.[39]

Designation of some portion of the periodic payments as "interest." [40]

Of less importance, but still dangerous are successive one-year extensions of an option.[41] A bona fide lease-and-option arrangement usually provides for a rental calculated on the basis of depreciation of the property plus a reasonable return on the lessor's investment. The option to buy should be exercisable at depreciated cost or at the fair market value to be determined at the time of exercise.

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[32] 1954 IRC § 162(a)(3); 1939 IRC § 23(a)(1)(A), allowing as deductible expenses "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, *of property to which the taxpayer has not taken or is not taking title or in which he has no equity*." (Emphasis supplied.)

[33] *Rankin* v. *Commissioner* (6 Cir. 1932), 60 F. 2d 76, 11 AFTR 706; *Herryford* v. *Davis,* 102 U.S. 235, 244 (1880).

[34] *Benton* v. *Commissioner* (5 Cir. 1952), 197 F. 2d 745, 42 AFTR 229; *Eterpen Financiera Sociedad* v. *United States* (Ct. Cls. 1952), 108 F. Supp. 100, 42 AFTR 831. In an unpublished ruling the Bureau has indicated it will follow the Benton case, but will attach particular importance to the factors outlined in the text. The Benton case rejected "objective" tests in determining whether a sale or lease was intended. Cf. *Commissioner* v. *Culbertson,* 337 U.S. 733, 37 AFTR 1391 (1949).

[35] *Truman Bowen,* 12 T.C. 446 (1949).

[36] *Truman Bowen,* footnote 35, above; *Hervey* v. *Rhode Island Locomotive Works,* 93 U.S. 664 (1877); *Helser Machine & Marine Works, Inc.,* 39 B.T.A. 644 (1939); *Robert A. Taft,* 27 B.T.A. 808 (1933).

[37] *Truman Bowen,* footnote 35, above.

[38] *William A. McWaters,* par. 50,152, Prentice-Hall Memorandum T.C. (1950); *L. M. Graves,* par. 52,143, Prentice-Hall Memorandum T.C. (1952).

[39] This factor is deemed present when the option price is less than the value of the property as of the time of exercise, estimated at the time of the original agreement, or when relatively small compared to the total of payments to be made. *Burroughs Adding Machine Co.* v. *Bogdon* (8 Cir. 1925), 9 F. 2d 54; *Holeproof Hosiery Co.,* 11 B.T.A. 547 (1928); Truman Bowen, footnote 35, above; *Benton* v. *Commissioner,* footnote 34, above. A nominal option price may also accompany excessive rentals. *Watson* v. *Commissioner* (9 Cir. 1932), 62 F. 2d 35, 11 AFTR 1051; *Judson Mills,* 11 T.C. 25 (1948); *Alexander W. Smith, Executor,* 20 B.T.A. 27 (1930).

[40] *Judson Mills,* footnote 39, above. It will be sufficient if portions of the periodic payments are readily recognizable as the equivalent of interest, although not specifically so designated.

[41] *Rankin* v. *Commissioner,* footnote 33, above.

A long-term lease with no option to buy may also be used in lieu of a sale of machinery and equipment. A lease term exceeding the depreciable life of the equipment might be used, either directly or by means of renewal options.[42] The rental is calculated to return cost of the equipment plus carrying charges plus a profit. Here, the owner of property chooses to obtain return of his investment as ordinary income spread over a long period and the purchaser obtains rental deductions for what is equivalent to purchase price.

6. Installment Sales

Sales in which the consideration is to be paid, wholly or in part, in the future, are classified by the Regulations[43] as "installment sales" or "deferred payment sales." An "installment sale" is specially defined by statute.[44] Any other sale on deferred payment terms is defined as a "deferred payment sale." [45]

On an installment sale, the vendor is permitted to spread his tax over the payments as they are received. The vendor reports as income the percentage of each payment that the total gross profit on the sale bears to the total contract price. Thus, if the total contract price is $5,000, payable in five equal annual installments, and the total gross profit is $500, the vendor reports 10 per cent of each $1,000 installment received as income.

The installment method is available only for certain types of sales, and under certain carefully defined conditions. These are as follows:

1. Sales of personal property by *regular* dealers therein.
2. Casual sales of personal property, where the selling price exceeds $1,000 and the initial payments do not exceed 30 per cent of the selling price.
3. Mixed sales of real and personal property[46] (for example, sale of a business) conforming to both of the conditions in 2. above.
4. Any sale of real property, where the initial payments do not exceed 30 per cent of the selling price.[47]

The advantages of an installment sale may be summarized as follows:

(a) It permits precise correlation of tax payments with the installments of sale proceeds. Thus, it avoids an excessive tax in the year of sale, which might otherwise exceed the down payment received.

(b) Where the property sold is a capital asset (or business property, as defined in

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[42] Reduction in the rental to a nominal sum after the property is fully depreciated should be avoided, lest the lessee be deemed to have acquired an equity in the property, even though no specific option *to purchase* is present.

[43] Reg. 118, § 39.44-2.

[44] 1954 IRC § 453; 1939 IRC § 44.

[45] Reg. 118, § 39.44-2(2).

[46] *Arkay Drug Co.*, par. 44,364, Prentice-Hall Memorandum T.C. (1944); *W. D. Parker*, et al., 13 B.T.A. 1239 (1928).

[47] Gain on the sale of a personal residence, to the extent recognized under 1954 IRC § 1034; 1939 IRC § 112(n), may be reported on the installment basis if otherwise qualified. Rev. R 75, 1953 Prentice-Hall Fed. Tax Ser., par. 76,488 (May 11, 1953).

1954 Code Section 1231; 1939 Code Section 117(j)), it permits spreading the capital gain in installments. Thus, capital losses of future years may be used to absorb installments of gain. The benefit of such capital losses might otherwise be lost.

The installment method *must* be elected on the taxpayer's return for the year of sale.[48] Express election is not necessary if the return discloses the facts of sale and applies installment treatment.[49]

Under the Internal Revenue Code of 1954, in the case of sales during a taxable year beginning after December 31, 1953, no payments need be made in the year of sale, but if any payments are made they may not exceed thirty per cent of the selling price.[50] The Secretary was given authority to issue regulations concerning sales of realty and casual sales of personalty.[51] Presumably regulations will be issued defining payments in the year of sale in the same way "initial" payments were previously defined by the statute. "Initial payments" were defined by the 1939 Code as "the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made." [52]

Major pitfalls in applying this definition, and the remedies therefor, are as follows:

Defect	*Result*	*Remedy*
Down payment plus first installment in same year.	Total exceeds 30 per cent of selling price.[53]	Segregate all payments in separate years.
Down payment and first installment in separate years but "sale" incidents in second year	Down payment lumped with first installment in second year.[54]	Be sure title or possession given in year of down payment.
Property other than *purchaser's* notes received, such as third party notes or stock.	Counted in initial payments, thus exceeding 30 per cent of selling price.[55]	Escrow *by purchaser* of all such property until first installment.[56]

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[48] *Sylvia S. Strauss,* 33 B.T.A. 855 (1935); *W. T. Thrift, Sr.,* 15 T.C. 366 (1950). But, where a partnership failed to elect the installment method on sale of its assets, the election is not available to an individual partner (even though the partnership is not a "taxpayer"). *John G. Scherf, Jr.,* 20 T.C. 346 (1953).

[49] *United States* v. *Eversman* (6 Cir. 1943), 133 F. 2d 261, 30 AFTR 761.

[50] 1954 IRC § 453(b)(2)(A). Under the prior law, if there were no payment by the purchaser for the year of sale, the transaction did not qualify as an installment sale. *Wagegro Corporation,* 38 B.T.A. 1225 (1938). This rule still applies to sales during years prior to 1954. 1954 IRC § 453(b)(2)(B); 1939 IRC § 44(b); Regs. 118, § 39.44-2.

[51] 1954 IRC § 453(b)(1).

[52] 1939 IRC § 44(b).

[53] *Gertrude H. Sweet,* 8 B.T.A. 404 (1927). In *J. J. Hastings,* par. 52,113, Prentice-Hall Memorandum T.C. (1952), the purchaser of stock on the installment basis promptly caused the corporation to pay him a dividend. The Commissioner contended that the dividend reduced the total contract price, causing the down payment to exceed 30 per cent of such price. The contention was abandoned at the trial.

[54] *Newaygo Portland Cement Co.,* 27 B.T.A. 1097 (1933).

[55] *Caldwell* v. *United States* (3 Cir. 1940), 114 F. 2d 995, 25 AFTR 769.

[56] *Gibbs & Hudson, Inc.,* 35 B.T.A. 205 (1936). Escrow of the entire balance of the price after the down payment does not destroy the seller's installment basis privilege. *Rebecca J. Murray,* 28 B.T.A. 624 (1933).

Defect	*Result*	*Remedy*
Mortgage assumed by purchaser in amount exceeding vendor's basis for property.	Excess is treated as initial payment.[57]	Reduce other cash consideration until excess is less than 30 per cent of selling price.
Entire business sold as unit in one contract.	Cash for liquid assets exceeds 30 per cent of total.[58]	Split sale into two contracts; sell inventory for cash; plant and fixtures on installments.[59]
Reimbursement of vendor for commissions, fees and other expenses of sale.	Counted as initial payments, causing excess initial payment.[60]	Direct purchaser to pay vendor's obligations directly.[61]

Gain or loss is realized by the vendor if he disposes of the installment obligations, either by sale or distribution, with certain statutory exceptions for distribution on death and in the liquidation of a wholly-owned subsidiary.[62] The purchaser, however, does not succeed to the benefits of the installment sales.[63] While the obligations cannot be discounted directly, it may be possible to use them as collateral for a loan without tax consequences.[64]

7. Deferred Payment Sales

In any sale, other than an installment sale, the vendor reports in the year of sale the cash received plus the fair market value of any property received (including obligations of the purchaser) for purposes of measuring gain or loss.[65]

However, if the property or obligations received have no fair market value, the vendor reports only the cash received, if any, in the year of sale. Gain is taxed, to the extent that the cash exceeds the vendor's basis for the property sold. No loss is allowable in the year of sale.[66] The value of the deferred payments is taken into account only if and when such payments are received.

The Regulations state: "Only in rare and extraordinary cases does property have no fair market value." [67]

In general, property has no fair market value if it is not salable by the vendor, or if it is affected by substantial contingencies that make determination of its present worth impossible.

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[57] *Therese C. Johnson*, 7 T.C. 465 (1946), affirmed (5 Cir. 1947) 162 F. 2d 844, 35 AFTR 1568.

[58] *Arkay Drug Co.*, footnote 46, above.

[59] Such segregation is also desirable because the sale of inventory results in ordinary income, while the sale of other business assets may produce capital gain. 1954 IRC § 1231; 1939 IRC § 117(j); *Williams* v. *McGowan* (2 Cir. 1945), 152 F. 2d 570, 34 AFTR 615. Accord, *Watson* v. *Commissioner*, 345 U.S. 544, 43 AFTR 621 (1953). Cf., contra, *Hatch Est.* v. *Commissioner* (9 Cir. 1952), 198 F. 2d 26, 42 AFTR 296, where the court concluded that the subject of the sale was a partnership interest, a capital asset, but approved the dissenting opinion in *Williams* v. *McGowan*. A point of possible distinction lies in the fact that in the Hatch case inventory was sold at cost; gain was derived largely from the sale of good will.

[60] *Wagegro Corp.*, footnote 51, above.

[61] *Katherine H. Watson*, 20 B.T.A. 270 (1930).

[62] 1954 IRC § 453(d); 1939 IRC § 44(d).

[63] *Title & Trust Co.*, 33 B.T.A. 25 (1935).

[64] *Miller Saw-Trimmer Co.*, 32 B.T.A. 931 (1935).

[65] Reg. 118, § 39.44-4.

[66] *First Nat. Corp.* v. *Commissioner* (9 Cir. 1945), 147 F. 2d 462, 33 AFTR 701.

[67] Reg. 118, § 39.44-4.

The following types of property have been held to be unsalable, hence to lack fair market value:

A bare contract obligation of the purchaser to pay installments in the future, not secured by any obligations of the purchaser.[68]

Non-negotiable promissory notes.[69]

Notes or other property escrowed by the purchaser for future payments.[70]

Annuities payable by an individual purchaser[71] (but not annuities guaranteed by an insurance company or charitable institution).[72]

Speculative securities containing restrictions against sale for a definite period[73] (but the contrary has been held where the stock is stable or the restriction short).[74]

Contingencies that have been held to prevent the ascertainment of a present fair market value are as follows:

Payments for stock of a natural resource company, to be made only out of future production of the natural resource.[75] This rule does not apply to direct sales of the mineral interest.[76]

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[68] *Ruprecht* v. *Commissioner* (5 Cir. 1930), 39 F. 2d 458, 8 AFTR 10534; *Bedell* v. *Commissioner* (2 Cir. 1929), 30 F. 2d 622, 7 AFTR 8469; *Fidelity Savings & Loan Co.*, 44 B.T.A. 471 (1941); *C. W. Titus, Inc.*, 33 B.T.A. 928 (1936); *W. A. Hoult*, 23 B.T.A. 804 (1931); *A. W. Henn*, 20 B.T.A. 1133 (1930); *Old Farmers' Oil Co.*, 12 B.T.A. 203 (1928); G.C.M. 3350, VII-1 C.B. 62 (1928); *Nina J. Ennis*, 17 T.C. 465 (1951); *Harold W. Johnston*, 14 T.C. 560 (1950).

[69] *Dudley T. Humphrey*, 32 B.T.A. 280 (1935). Even though negotiable, proof that the obligations had fair market value when received of less than face value is acceptable. *Nichols* v. *Commissioner* (3 Cir. 1930), 44 F. 2d 157, 9 AFTR 285; *Harris Trust & Savings Bank, Executor*, 24 B.T.A. 498 (1931). But if an amount is subsequently realized from the obligations in excess of the fair market value so determined, the excess constitutes ordinary income, not capital gain. *A. B. Culbertson*, 14 T.C. 1421 (1950); *Victor B. Gilbert*, 6 T.C. 10 (1946). See, also, *Fisher Brown*, par. 50,288, Prentice-Hall Memorandum T.C. (1950), which raises doubt whether the rule stated in the text applies to accrual-basis taxpayers.

[70] *McLaughlin* v. *Commissioner* (7 Cir. 1940), 113 F. 2d 611, 25 AFTR 435; *Merton E. Farr*, 11 T.C. 552 (1948), affirmed sub. nom. *Sloane* v. *Commissioner* (6 Cir. 1951) 188 F. 2d 254, 40 AFTR 433; *Mobile Light & Railroad Co.* 23 B.T.A. 543 (1931); *Harold W. Johnston*, footnote 68, above.

[71] *Bella Hommell*, 7 T.C. 992 (1946); *Frank C. Deering*, 40 B.T.A. 984 (1939); *J. Darsie Lloyd*, 33 B.T.A. 903 (1936); *Donald H. Sheridan*, 18 T.C. 381 (1952); *Commissioner* v. *Kann's Est.* (3 Cir. 1949), 174 F. 2d 357, 37 AFTR 1434.

[72] *Anna L. Raymond*, 40 B.T.A. 244 (1939), affirmed (7 Cir. 1940) 114 F. 2d 140, 25 AFTR 583.

[73] *Helvering* v. *Tex-Penn Oil Co.*, 300 U.S. 481, 18 AFTR 1174 (1937); *United States* v. *State Street Trust Co.* (1 Cir. 1942), 124 F. 2d 948, 28 AFTR 871; *Robert Lehman*, 17 T.C. 652 (1951), gov't appeal dismissed (2 Cir. June 18, 1952); *Harold H. Kuchman*, 18 T.C. 154 (1952); *Society Brand Clothes, Inc.*, 18 T.C. 304 (1952). In *Lehman* it was held that the emergence of ascertainable value, i.e., the termination of restrictions, was not a taxable event.

[74] *Heiner* v. *Gwinner* (3 Cir. 1940), 114 F. 2d 723, 25 AFTR 713; *G. & K. Mfg. Co.* v. *Commissioner* (4 Cir. 1935), 76 F. 2d 454, 15 AFTR 1145; see *Trinity Corp.* v. *Commissioner* (5 Cir. 1942), 126 F. 2d 604, 29 AFTR 352.

[75] *Burnet* v. *Logan*, 283 U.S. 404, 9 AFTR 1453 (1931); *Helvering* v. *O'Donnell*, 303 U.S. 370, 20 AFTR 785 (1938); *Haynes* v. *United States* (Ct. Cls. 1943), 50 F. Supp. 238, 31 AFTR 281; *Tuttle* v. *United States* (Ct. Cls. 1951), 101 F. Supp. 532, 41 AFTR 549; *George W. Potter*, par. 48,167 Prentice-Hall Memorandum T.C. (1948); *Lee H. Peck*, par. 52,203 Prentice-Hall Memorandum T.C. (1952); *William A. Cluff*, 17 T.C. 225 (1951).

[76] The owner of a mineral interest is deemed to have retained an "economic interest" where

Payments on the sale of a business, to be made only out of future earnings of the business.[77]

Payments on the sale of patents, or patented machinery, to be made only out of future royalties thereon.[78]

Payments conditioned on the discharge by the purchaser of prior obligations, such as a mortgage on the property, or a bond issue of a corporation.[79]

Payments conditioned on the test and acceptance of equipment by the purchaser.[80]

Payments conditioned on the dissolution of a corporation.[81]

Payments that are escrowed, before or after receipts by the vendor, as a guaranty against subsequent contingencies.[82]

On the other hand, the following conditions affecting payments have been held not to prevent ascertainment of fair market value or defer reporting of income by the vendor:

Payments that may be adjusted upwards or downwards by a subsequent survey of the acreage, count of the inventory, or other factors adjusting price.[83]

Payments received by the vendor without restriction, which are subsequently determined not to belong to him, by reason of lack of title, fraud, etc.[84]

Payments that are escrowed, where the vendor receives the benefits of ownership during the escrow period.[85]

It should be observed that the general distinction is between conditions precedent, which defer tax on the vendor, and conditions subsequent, which do not. Frequently, this difference is a matter of form, which can be controlled in setting up the transaction. For example, if the contract requires that a portion of the consideration be escrowed by either party, to be paid only if X event occurs, the vendor

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he sells it for a consideration payable only out of future production of the mineral. Hence, there is no "sale," and the proceeds are ordinary income. *Palmer* v. *Bender*, 287 U.S. 551, 11 AFTR 1106 (1933); *Thomas* v. *Perkins*, 301 U.S. 655, 19 AFTR 538 (1937); see *Anderson* v. *Helvering*, 310 U.S. 404, 24 AFTR 967 (1940). A stockholder, on the other hand, has no "economic interest" in the mineral property held by his corporation. See *Helvering* v. *O'Donnell*, footnote 75, above.

[77] *Carter* v. *Commissioner* (2 Cir. 1948), 170 F. 2d 911, 37 AFTR 573; *United States* v. *Yerger* (E.D. Pa., 1944), 55 F. Supp. 521, 32 AFTR 855.

[78] *Westover* v. *Smith* (9 Cir. 1949), 173 F. 2d 90, 37 AFTR 1001; *Commissioner* v. *Hopkinson* (2 Cir. 1942), 126 F. 2d 406, 28 AFTR 1349.

[79] *Big Lake Oil Co.* v. *Commissioner* (3 Cir. 1938), 95 F. 2d 573, 20 AFTR 1134; *Brown* v. *Commissioner* (5 Cir. 1934), 69 F. 2d 863, 13 AFTR 896.

[80] *Webb Press Co., Ltd.*, 3 B.T.A. 247 (1925).

[81] *Michigan Steel Corp. of N. J.*, 38 B.T.A. 435 (1938).

[82] *Marion H. McArdle*, 11 T.C. 961 (1948); *Preston R. Bassett*, 33 B.T.A. 182 (1935); affirmed (2 Cir. 1937) 90 F. 2d 1004, 19 AFTR 1001; *Stoner* v. *Commissioner* (3 Cir. 1935), 79 F. 2d 75, 16 AFTR 598, cert. den. 296 U.S. 650; *Commissioner* v. *Cleveland Trinidad Pav. Co.* (6 Cir. 1932), 62 F. 2d 85, 11 AFTR 1059.

[83] *Commissioner* v. *R. J. Darnell, Inc.* (6 Cir. 1932), 60 F. 2d 82, 11 AFTR 711.

[84] *Frederick S. Buggie*, 32 B.T.A. 581 (1935); see *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 11 AFTR 16 (1932).

[85] *Federal Development Co.*, 18 B.T.A. 971 (1930) (interest on escrowed funds); *Bonham* v. *Commissioner* (8 Cir. 1937), 89 F. 2d 725, 19 AFTR 577 (as to escrowed stock, voting rights, dividend rights, appreciation of value, and the right to the specific stock when no longer needed as collateral); *Whitney Corporation* v. *Commissioner* (8 Cir. 1939), 105 F. 2d 438, 23 AFTR 183 (dividends on escrowed stock, which was also stipulated to have a fair market value and was not speculative; compare *Helvering* v. *Tex-Penn Oil Co.*, footnote 73, above).

has not received the escrowed amount and it is not taxable to him. If, however, the full purchase price is paid to the vendor without restriction, he will be taxable on the full amount received, even though he may remain liable to repay a portion of the consideration if X event occurs.

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Sales for an Annuity

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The sale of property in exchange for a commercial annuity is comparable to a sale for cash, followed by a reinvestment of the proceeds in a non-speculative investment. The transaction is considered closed for tax purposes. The value of the commercial annuity contract received, less the basis of the property sold, constitutes capital gain.[1] A proportionate part of each annuity payment is considered to be a return of capital, and thus excludable from income; the balance is ordinary income.[2]

The effects of a private annuity are far more complex. In this type of transaction, there is a disposition of property in return for the promise of a non-commercial annuity writer, individual or corporate, to pay a stated amount periodically for life. The promise of one not engaged in the annuity business, and thus freed from comparable regulation and investment restrictions, to make annual payments for life is not considered to have an ascertainable fair market value. Thus, no gain or loss is realized when the sale is made; the seller only includes payments received in excess of his basis as capital gain.[3]

If only this deferred payment aspect of the transaction were involved, outlining the tax results would not be unduly difficult. But the consideration paid by the purchaser is not a fixed amount; it is cast in the form of an annuity, the taxation of which is detailed in the tax law.[4] The compulsion felt by many courts to treat a purchase in exchange for an annuity differently from that made for a cash sum, or for property, has largely been responsible for the unsettled state of the governing rules.[5]

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[1] 1954 IRC § 1001; 1939 IRC § 111.

[2] Under 1954 IRC § 72 the exempt portion of the annuity equals the annuitant's investment in the annuity contract divided by his life expectancy. This exclusion remains constant even though the recipient outlives his expectancy.

The treatment imposed by 1939 IRC § 22(b)(2) was quite different. Three per cent of the consideration paid for the annuity was ordinary income; the balance was excluded from income until the total of the excluded receipts equalled the value of the annuity. Thereafter the entire annual payment was included as taxable income.

[3] *Commissioner* v. *Est. of Kann* (3 Cir. 1949), 174 F. 2d 358, 37 AFTR 1434; *J. Darsie Lloyd,* 33 B.T.A. 903 (1936) Acq. 1950-2 C.B. 3; *Bella Hommel,* 7 T.C. 992 (1946) Acq. 1950-2 C.B. 3.

[4] Footnote 2, above.

[5] The House of Representatives, 83rd Congress, incorporated in the 1954 Internal Revenue Code a section defining the tax consequences of an exchange of property for a private annuity contract effected after the effective date of the new Code (H.R. 8300, § 1241). The new provision was rejected by the Senate which found the quest for certainty in this field praiseworthy,

Notwithstanding the lack of definite predictability of all consequences, the private annuity has a great deal of appeal in certain situations—particularly in intra-family affairs. For example:[6]

Seller,[7] advanced in years, is the controlling stockholder in a corporation in which his two sons are minority stockholders. He derives a substantial part of his income from the corporation in the form of salary and dividends. Seller's stock is now worth much more than his basis for it. His stock constitutes the bulk of his estate and he has the problem of figuring out how his estate can get enough liquidity to pay all taxes and expenses, without being forced to sell the stock. He would like to retire and give his sons complete ownership and control of the corporation. But he refuses to be dependent upon them during his lifetime.

In circumstances such as these, seller might react very favorably to the idea of transferring his stock to the corporation,[8] or to his sons, for an annuity for life. In the first part of this chapter the tax effects of such an annuity on the seller will be examined. At the end of the chapter the purchaser's tax picture will be viewed.

1. Points to Consider

Section
The Seller 2
  Income tax treatment .... a
  Gift Tax .... b
  Estate Tax c
The Purchaser 3
  Interest deduction .... a
  Basis .... b
  Loss c
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2. The Seller

a. **Income tax treatment.** No gain or loss is realized when the sale is made.[9] This enables the seller to procure a more favorable annuity than he could by making an ordinary sale and buying a commercial annuity. The proceeds available for a commercial annuity would be net *after taxes.* To illustrate:[10] Property with a basis of $200,000 is sold for $500,000, its fair value, by seller, 65 years old. After the pay-

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but felt further study of the operation of the proposed rules was necessary (Sen. Rep. No. 1622, 83rd Cong., 2nd Sess. p. 116). The House-Senate conferees concurred in the deletion of the section (Amendment No. 251).

[6] Some detailed examples can be found in J. K. Lasser, "How to Use The Private Annuity," *Business Reports, Inc.*, May 15, 1953, and Roland K. Smith, "Shifting Income Within the Family Group," *Taxes*, December, 1952, Vol. 30, page 995.

[7] The person exchanging property for the private annuity is referred to herein as the seller. The person acquiring the property, and promising to pay the annuity, is called the purchaser.

[8] This chapter does not consider some of the problems which might result from the corporation's participation in this kind of transaction.

[9] Footnote 3, above. The private annuity section enacted by the House of Representatives, see footnote 5, above, would have altered this. The sale would have constituted a taxable event, with the seller realizing gain to the extent of the difference between his basis and the value of the annuity contract. This value was to be the amount which an insurance company would charge for a contract with similar terms.

[10] In making all computations, figures have been rounded out for simplicity.

ment of maximum capital gains tax, the balance of $425,000 will give seller a nonrefund commercial annuity of $33,000 for life. In a private annuity deal, the $500,000 value would bring an annuity of $39,000, based on insurance company rates.

The payments received by the seller have a dual character. As installments of the purchase price, they are first applied against the basis of the property until the basis is exhausted.[11] Payments in excess of the basis are taxed as capital gain until the total amount received equals the "consideration paid"[12] for the annuity contract.[13]

Each installment is also an annuity payment. As such, an amount equal to the "consideration paid" divided by the seller's life expectancy is excluded from income. The balance is taxed as ordinary income.[14]

In a case[15] explaining the interplay of the two taxable aspects of the transaction, the Court held that in computing the capital gain realized, the taxable portion of the annuity should not be deducted. A 1953 ruling[16] of the Commissioner, however, is more liberal. Here is the way the ruling would handle it,[17] assuming a consideration of $30,000, a basis of $10,000, an annual payment of $2,400 and a life expectancy of 15 years:

Each year during the seller's lifetime, he excludes from income $2,000 ($30,000 ÷ 15). The $400 balance of the annuity comprises ordinary income. The nontaxable portion ($2,000) is applied against the seller's basis. At the end of the 5th year, the entire $10,000 basis will have been recovered. Thereafter, from the 6th through the 15th year, this $2,000 is reported as capital gain. After the 15th year, no further gain is reportable since the total capital gain of $20,000 ($30,000 consideration paid minus $10,000 basis) has been taxed.[18]

The determination of the consideration for the annuity is crucial for computations of capital gain and ordinary income. The above-mentioned ruling and some cases[19] hold that it is market value. On the other hand, the consideration has been held to be the cost of a comparable commercial annuity;[20] and a suggestion has been made that it should be the basis of the property exchanged.[21]

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[11] Footnote 3, above.

[12] 1954 IRC § 72 refers to the annuitant's "investment in the contract." This is defined in § 72(c) as the total premiums or other consideration paid for the contract. In a private annuity exchange there are no premium payments so that the investment consists entirely of the "consideration paid."

[13] *Hill* v. *Maloney* (D.C., N.J. 1944), 58 F. Supp. 164, 33 AFTR 479.

[14] Footnote 2, above; *Ware* v. *Commissioner* (5 Cir. 1947), 159 F. 2d 542, 35 AFTR 809.

[15] *Hill* v. *Maloney*, footnote 13, above.

[16] Rev. Rul. 239, 1953-2 C.B. 53.

[17] The determinations set out in the ruling have been altered to reflect the changes in the manner of taxing annuities made by 1954 IRC § 72.

[18] Under the assumed facts, the new law is more favorable than the old. Under 1939 IRC, $900 (3 per cent of $30,000), rather than $400, would be includible annually as ordinary income. At the end of 20 years, when the sum of the $1,500 annual exclusions equalled the cost of the annuity contract ($30,000), the entire payment would be taxed as ordinary income.

These disadvantages under the former Code are offset only by the delayed taxation of the capital gain. The seller's basis would not be exhausted until the 7th year, as compared to the 5th under the 1954 IRC. And only $1,500, instead $2,000, would be reportable in subsequent years. However, the trade of increased ordinary income for potentially decreased capital gain is unprofitable.

[19] *F. A. Gillespie*, 38 B.T.A. 673 (1938), Acq. 1939-1 C.B. 13; *Beattie* v. *Commissioner* (6 Cir. 1947), 159 F. 2d 788, 35 AFTR 843.

Sometimes the seller will want to receive a certain annuity sum even though the value of the property he is giving up would call for a greater amount. In that event, the agreement should clearly evidence the two aspects of the transaction: (a) A sale of such part of the property as would command from an insurance company the desired annuity; and (b) A gift of the balance. The combination gift-sale has been recognized.[22]

Because of the method of taxing annuities, the seller may have more net income after taxes—notwithstanding the annuity is less than the annual return from the property. For example, the annual income from property worth $500,000 is $50,000. Seller, a widower, aged 65, has other income of $10,000 in excess of deductions and exemptions. His tax on the total income of $60,000 is $34,300—net after taxes is $25,700.

Based on equivalent commercial annuities, his $500,000 property would get him a $39,000 annuity. Because only $5,700 of it is includible in income,[23] his total taxable income is reduced to $15,700. His net after tax of $5,100 is $43,900. Thus, spendable income is actually increased $18,200.[24]

The death of the seller before he has recovered his cost will probably not entitle his estate to a loss deduction. He will be considered to have received exactly what he contracted for.[25]

b. Gift tax. Gifts are often employed in estate planning to reduce the potential gross estate. The attempt is made to balance the low gift and estate tax brackets. The private annuity may accomplish the same purpose for the seller, but it does it without gift tax. Thus, the transfer by a widower of property having a value of $500,000, in exchange for an annuity reflecting that value, saves approximately $100,000 in gift tax.

A difference between the value of the property and the value of the annuity will probably be treated as a gift.[26] This emphasizes the importance of obtaining a reliable appraisal of property which is difficult to value. A deal based on such appraised value does not bespeak a gift.

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[20] *Raymond* v. *Commissioner* (7 Cir. 1940), 114 F. 2d 140, 25 AFTR 583, cert. den. 311 U.S. 710 (1940); *Gillespie* v. *Commissioner* (9 Cir. 1942), 128 F. 2d 140, 29 AFTR 480, affirming 43 B.T.A. 399 (1941).

[21] See Rabkin & Johnson, *op. cit.*, footnote 14, above.

[22] *Donald H. Sheridan*, 18 T.C. 381 (1952) Acq. 1952-2 C.B. 3; *Hirsh* v. *U.S.* (Ct. Cls. 1929), 35 F. 2d 982, 8 AFTR 9812; *Raymond* v. *Commissioner*, footnote 15, above; *Gillespie* v. *Commissioner*, footnote 15, above.

[23] For the purposes of this illustration a life expectancy of 15 years has been used for the 65 year old taxpayer. This gives an exclusion of $33,300 ($500,000 ÷ 15) and makes the balance of $5,700 taxable as ordinary income.

This expectancy of 15 years was obtained from table I set out in Proposed Temporary Rules, published in the Federal Register on August 27, 1954 (545 CCH par. 6403). The statute specifically provides for the determination of life expectancy from actuarial tables prescribed by the Secretary of the Treasury or his delegate. 1954 IRC § 72(c)(3)(A).

[24] When total receipts exceed seller's basis for the property sold, capital gain tax on each payment will reduce the tax benefit.

[25] *Industrial Trust Co.* v. *Broderick* (1 Cir. 1938), 94 F. 2d 927, 20 AFTR 38, cert. den. 304 U.S. 572 (1938); *Helvering* v. *Louis* (App. D.C. 1935), 77 F. 2d 386, 15 AFTR 1415.

[26] *Est. of Koert Bartman*, 10 T.C. 1073 (1948), Acq. 1948-2 C.B. 1 and *Est. of Sarah Bergan*, 1 T.C. 543 (1943), Acq. 1943 C.B. 2 (both cases using the Commissioner's tables to find the annuity value); see footnote 22, above.

A program of gifts in conjunction with the sale for the annuity may be advisable. Each year seller receives income, and to the extent it is not expended his estate starts to increase. If the seller lives a full life he could be placed back in the same estate tax position he was in before the sale.

Annual gifts of all or a substantial part of the unneeded income can be employed to keep the estate tax down, and at the same time to make earlier distributions to the ultimate recipients of the estate. The annual exclusion, and gift splitting opportunities can permit this to be done with little or no gift tax. If the purchaser is related to the seller, as in the original example given, gifts to the purchaser of the excess part of the annuity can reduce the purchaser's burden and make the transaction more favorable to him.

c. Estate tax. Eliminating $500,000 of property from an estate can mean substantial estate tax savings—$175,000 if the estate is in the 35 per cent bracket. There is also a reduction in state taxes and administration costs. To accomplish this without gift tax, and with the reservation of an annual stipend for life, makes for an extremely desirable estate planning tool.

The private annuity has been suggested as the means for achieving this unique result. Viewed as a transfer for an adequate consideration in money's worth, it would not be subject to estate tax.[27] It is, however, very similar to the taxable transfer of property with the transferor retaining the income or enjoyment of the property during his lifetime.[28] There is a distinction. In the case of the sale for an annuity the uncertain earnings from the property have been replaced by an obligation to pay a sum certain—irrespective of earnings.[29] Where the income from the property is stable, and the amount of the annuity approximates that income, the materiality of the distinction is not great.

There are several cases holding that the arrangement is not one intended to take effect in possession or enjoyment at death.[30] It has also been held that the transaction is not a transfer with the income reserved for life.[31] Nevertheless, there are expressions indicating that the private annuity may not give the seller favorable estate tax treatment.[32]

Pending clarification of the law on this point, every attempt should be made to try and differentiate the sale, as much as possible, from the usual transfer reserving income, possession or enjoyment. Here are some things which should be observed:

a. The transfer must be complete and must vest in the purchaser immediate possession and enjoyment.

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[27] 1954 IRC § 2036(a); 1939 IRC § 811(c)(1). Even where the consideration is inadequate, it can be urged that only the difference between the value of the property at the time of the Seller's death and the annuity value is includible in the seller's estate. 1954 IRC § 2043(a); 1939 IRC § 811(i).

[28] 1954 IRC § 2036(a)(1); 1939 IRC § 811(c)(1)(B).

[29] *Cf. Security Trust & Savings Bank,* 11 B.T.A. 833 (1928).

[30] *Est. of Sarah Bergan,* footnote 26, above. *Lincoln* v. *U.S.,* 65 Ct. Cls. 198, 6 AFTR 7441 (1928); *Hirsh* v. *U.S.,* footnote 18, above; *Security Trust & Savings Bank,* footnote 29, above.

[31] *Est. of Sarah Bergan,* footnote 26, above; and see *Hill* v. *Maloney,* footnote 13, above.

[32] The transfer is characterized as one with the reservation of income for life. See Judge O'Connell dissenting in *Commissioner* v. *Est. of Kann,* footnote 3, above; Roland K. Smith, op. cit., footnote 6, above (his footnote 30).

b. Limitations on the right to use, sell, or otherwise dispose of the property must be avoided.[33] Pledging the property to secure the purchaser's compliance is inadvisable.

c. The annuity to be paid should be a fixed amount. If the seller has the right to the net income from the property for life, the value of the property will remain a part of his estate.[34] It will also cause him to be taxed on all of the income received rather than on just the amount includible under the annuity rules.[35]

d. To counteract a finding of an implied right to the net income of the property, there should be a significant difference between the amount of the annuity and the anticipated income of the property—or the expected income should be difficult to predict with assurance.[36]

e. Handle the sale in a businesslike way. Value the property in the same manner that persons dealing at arm's length would. Base the amount of the annuity on what an insurance company would pay for a like premium. This will help to characterize the transfer as one for an adequate consideration.

3. The Purchaser

To acquire the income-producing property, the purchaser obligates himself to pay to the seller a fixed amount per annum. The income from the property will usually exceed the payment at the outset, if the sale is set up as an arm's length deal. The purchaser would normally demand this, since he runs the risk of a decrease in value or earnings, while the seller's return is fixed.

A spread between earnings and payment would at first glance make this private annuity arrangement appear very favorable to the purchaser. He would seemingly be financing the acquisition solely out of earnings. Unfortunately, the tax which he must pay on the earnings of the property may reduce the net after taxes to below the installment amount. This difference would have to be made up by dipping into capital. Naturally, there is no set rule for predicting whether capital will have to be supplied. That will depend on the amount of income, and the purchaser's tax bracket.

The tax picture of the purchaser after the property is acquired is hazy, and potentially calamitous. Let us look at his side of the sale:

a. Interest deduction. In applying the annuity rule to the installments received by the seller, the courts have essentially recognized that part of the payment is interest, and part, return of capital. Despite the apparent inconsistency, a deduction for the amount of such "interest" by the purchaser has not generally been permitted.[37] The contingent nature of the obligation has been held to prevent its being considered an "indebtedness" as contemplated by the Code.[38]

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[33] *Est. of Pamelia D. Holland*, 1 T.C. 564 (1943), Supp. opinion affirming 47 B.T.A. 807 (1942); *cf. Lincoln* v. *U.S.*, footnote 30, above.

[34] Footnote 28, above; *cf. Tips* v. *Bass* (D.C. W.D. Tex. 1927) 21 F. 2d 460, 6 AFTR 460.

[35] *Michael Fay*, 34 B.T.A. 662 (1936); *Sallie Cosby Wright*, 38 B.T.A. 746 (1938).

[36] *Cf. Est. of William F. Hofford*, 4 T.C. 790 (1945), modifying 4 T.C. 542 (1945), Non-Acq. 1945 C.B. 8.

[37] *Edwin M. Klein*, 31 B.T.A. 910 (1934), affirmed (7 Circ. 1936) 84 F. 2d 310, 17 AFTR 1289; *Reliable Incubator & Brooder Co.*, 6 T.C. 919 (1946); *F. A. Gillespie & Sons Co.* v. *Commissioner* (10 Cir. 1946), 154 F. 2d 913, 34 AFTR 1155, cert. den. 329 U.S. 781 (1946), rehearing den. 329 U.S. 831 (1946); *Steinbach Kresge Co.* v. *Sturgess* (D.C. N.J. 1940) 33 F. Supp. 897, 25 AFTR 533. *Contra: Commissioner* v. *John C. Moore Corp.* (2 Cir. 1930), 42 F. 2d 186, 8 AFTR 11080.

b. Basis. Conflicting conclusions have been reached with respect to the purchaser's basis for the property. Those who view the installments only as capital expenditures would limit the basis to the amount actually paid by the purchaser.[39] One court, adopting this view, suggested that even where the purchaser sold the property, the computation of gain or loss should be postponed until the seller's death.[40]

The Revenue Service, in July, 1955, released Rev. Rul. 55-119[41] dealing in detail with the matter of basis. For purposes of depreciation prior to the seller's death, basis is the value[42] of prospective payments.[43] When payments exceed this estimate, the basis is increased accordingly. After the seller dies, the basis is the sum actually paid.

What happens if the purchaser parts with the property before the seller's death? The ruling says that there are two bases, one for computing gain, the other for determining loss. The gain basis is the amount paid prior to sale, plus the value of future annuity installments. The loss basis is the amount paid prior to disposition. It is obvious, and the ruling acknowledges it, that there may be sales which give rise to neither gain nor loss.[44]

c. Loss. The seller's longevity may result in the purchaser's paying more than the value of the acquired property. In 1922, the Commissioner ruled that such excess was deductible if the transaction was entered into for profit.[45] This ruling was reaffirmed in a recent Tax Court case which allowed the deduction.[46] To secure this possible deduction the circumstances surrounding the sale should point up the undertaking of the obligation for good and adequate consideration.

In his 1955 ruling,[47] the Commissioner gives the following rules for reporting losses *after* the property is disposed of: (a) where a loss was recognized on the sale, all further annuity payments will be deductible;[48] (b) where a gain was realized on the sale, payments exceeding the basis used in computing the gain are deductible; (c) when neither gain nor loss is recognized on the sale, no loss is sustained until the annuity payments exceed the selling price.

The nature of the loss—ordinary or capital—depends upon the purpose for which the property was held.[49]

d. Gain. The sooner the seller dies, the greater is the purchaser's economic gain. But the tax consequences of an early death may be disastrous. The purchaser may have to include the difference between the value of the property when acquired and what he has paid for it as ordinary income. An example will illustrate how serious this can be. The seller transfers property worth $500,000, and he dies after receiving five installments of $39,000 each, or a total of approximately $200,000. The tax on the profit of $300,000 alone, for an unmarried taxpayer, would be about $247,000. A married couple splitting income would pay $223,000.

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[38] 1954 IRC § 163(a); 1939 IRC § 23(b). The provision proposed by the House of Representatives, see footnote 5, above, would have permitted an interest deduction equivalent to the annuity income taxable to the seller (H.R. 8300 § 1241(b)(2)).

[39] *D. Bruce Forrester*, 4 T.C. 907 (1945), Acq. 1945 C.B. 3 (note annuitant was dead at time of determination of basis); *cf. Mastin* v. *Commissioner* (8 Cir. 1928), 28 F. 2d 748, 7 AFTR 8208; *Scott* v. *Commissioner* (7 Cir. 1928) 29 F. 2d 472, 7 AFTR 8315.

[40] See *Steinbach Kresge Co.* v. *Sturgess*, footnote 37, above.

[41] IRB 1955-10, 10.

[42] The Service bases annuity values on Table I of Reg. 108 § 86.19(f).

[43] Cf. Nelson Trottman, par. 44,112 Prentice-Hall Memorandum T.C. (1944).

[44] E.g., a sale for $80,000 when total annuity payments equal $50,000, and the value of prospective payments is $50,000.

[45] I.T. 1242, I-1 C.B. 61.

[46] *Donald H. Sheridan*, footnote 22, above.

[47] Rev. Rul. 55-119, footnote 41, above.

[48] The deduction is taken in the year or years in which any excess is paid.

[49] Cf. *Arrowsmith* v. *Commissioner*, 344 U.S. 6 (1952).

There is no case squarely holding that the purchaser has a tax liability when the seller dies. It might be argued that the early death results only in giving the purchaser a low basis for the property—and that the gain is postponed until he disposes of it.[50]

The Tax Court, however, in the Sheridan case[51] stated flatly that the purchaser "stood to gain if his aunt died before the installments totalled $30,000, and the gain would have constituted taxable income to him." It relied upon language in the 1922 Bureau ruling.[52] Absent a sale or exchange in the year of death, the income would seem to be ordinary, and not long-term capital gain.

Under Rev. Rul. 55-119 [53] gain can result from events happening after the purchaser has transferred the property. If the total annuity payments ultimately made are less than the basis used in reporting the gain on the sale, the difference is taxable to the purchaser in the year of the seller's death. Similarly, where the disposition of the property produced neither gain nor loss, the purchaser may be taxed when the seller dies—to the extent that he has paid out less than his selling price. However, if the sale produced a loss, there will be no gain at the seller's death.

The character of the use of the property by the purchaser will determine whether the gain is ordinary income or capital gain.[54]

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[50] This is what the House of Representatives provided in H.R. 8300 § 1241, see footnote 5, above; and Rev. Rul. 55-119 supports this approach.

[51] Footnote 46, above.

[52] Footnote 45, above.

[53] Footnote 41, above.

[54] Footnote 49, above.

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How to Measure the Holding Period

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Whenever your client makes plans to sell or dispose of something, whether real estate, stocks, bonds, patents, his interest in a business or partnership, or any other property, he must think of his gain or loss for income tax purposes. If the property is a "capital asset" as defined in the Internal Revenue Code,[1] it is important for you to know whether your client's gain or loss will be "short-term" or "long-term." If the asset has been held for six months or less, the gain or loss is short-term; over six months, it is long-term.

Long-term gains are given more favorable tax treatment than short-term, the maximum tax rate being 25 per cent on net gains which are long-term.

It therefore becomes necessary for you to know how to measure the holding period. That question is answered in this chapter.

1. Points to Consider

Assume your client is about to sell some property which is a capital asset and wants you to tell him whether his gain or loss will be long-term or short-term. The first question you ask is how and when he acquired the property, and how and when he intends to dispose of it. When you know these facts, you will ask yourself these questions:

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[1] 1954 IRC § 1221 and 1231; 1939 IRC § 117(a) and (j).

2. General Rule

Where property is acquired in an outright purchase and is disposed of by an ordinary sale, the rule is quite simple: The holding period begins with the day following the purchase and ends on the day of the sale.[2]

On the other hand, special rules are applied if the property is acquired or disposed of by gift, inheritance, exchange, or some other more complicated transaction.

The rules may be summed up generally by stating that the holding period begins on the day next after the day on which the transaction that gives rise to the cost basis is completed,[3] and ends on the day in which is completed the transaction that disposes of the property.

Thus, holding period questions are closely related to the rules for determining the basis for gain or loss and to the rules for ascertaining when a transaction is treated as "closed" for tax purposes.

There are no statutory provisions telling you when a transaction is closed for tax purposes, but the courts have held that the holding period does not begin until the transaction by which the property is acquired has been sufficiently completed to constitute the taxpayer the "owner" of the property in question. If all your client has is an option or contract to buy property[4] or the right to receive property on termination of an escrow,[5] he is not, as yet, the owner and the holding period has not begun to run. Similar principles apply in determining the end of the holding period. However, if the taxpayer disposes of all the incidents of ownership, the transaction will be treated as closed, even though, for tax reasons, its form may be something other than a sale.[6]

So much for the general principles. We now turn to the rules applicable to specific types of transactions.

3. What Are the Special Problems Concerning Stocks, Bonds and Other Securities?

The general principles for determining the holding period apply to security transactions in the same manner as to other property. However, there are a number of special situations that require separate comment.

Identification of securities. It will sometimes happen, especially in the case of stocks and bonds, that your client will have difficulty in ascertaining the time of acquisition of property he is selling. For example, if he owns shares that he acquired in a reorganization in exchange for old shares of the same company that he acquired in different blocks at different times, he will have no definite means of identifying the new shares with any particular block of the old. A comparison of certificate numbers is sometimes helpful [7] but in many cases there is no relation between the old and new.[8]

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[2] *Weir,* 10 T.C. 996 (1948), affirmed (3 Cir. 1949) 173 F. 2d 222, 37 AFTR 1022; *Hooper,* 26 B.T.A. 758 (1932); I.T. 3287, 1939-1 (Part 1) C.B. 138; *Fogel,* 271; 51-789 Prentice-Hall Memorandum T.C. (1951).

[3] For two exceptions to this rule, see discussion (below) of residential property converted to business use, discussed in Section 6; and of property acquired by death where the optional valuation date is used, in Section 9.

[4] *Weir,* 10 T.C. 996 (1948), affirmed (3 Cir. 1949) 173 F. 2d 222, 37 AFTR 1022, *Helvering v. San Joaquin Fruit and Investment Co.,* 297 U.S. 496, 17 AFTR 470 (1936). But see discussion of stock exchange transactions in section 3.

[5] *Howell* v. *Commissioner* (5 Cir. 1944), 140 F. 2d 765, 32 AFTR 172. Cert. den. 322 U.S. 735; *Dyke,* 6 T.C. 1134 (1946).

[6] See *Kuzmick,* 11 T.C. 288 (1948); but see *Thompson,* 9 B.T.A. 1342 (1928).

Accordingly, the Regulations[9] have established what is called the "first-in, first-out" rule that creates a presumption to the effect that the first shares sold are derived from the earliest block acquired. It is intended to apply to any situation in which a satisfactory method of identifying property cannot be found.[10] The presumption of this rule can be overcome by actual proof of identification,[11] as where the taxpayer instructs his broker to sell shares from a particular block[12] or designates the certificate numbers of the shares to be sold. If the broker or taxpayer delivers the wrong shares, the shares actually sold are controlling.[13]

In some cases involving reorganizations that included more than one company it has been held that the first-in, first-out rule does not apply.[14] Instead, the cost has to be "averaged." [15] In such cases, the holding period may have to be apportioned among the new shares according to the times of acquisition of the various types and blocks of the old.[16]

Stock exchange transactions. When shares are bought and sold on the stock exchange, there are two dates involved. One is what is called the "execution date," which is the day on which the order is executed by the broker on the floor of the exchange. The other is the day on which the shares are delivered and the money paid, called the "settlement date." For purposes of the holding period, the execution date prevails.[17]

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[7] *Ford*, 33 B.T.A. 1229 (1936); *Bloch* v. *Commissioner* (9 Cir. 1945), 148 F. 2d 452, 33 AFTR 955.

[8] *Taber Estate* (1944), 3 TCM 151 (1944); *Arrott* v. *Commissioner* (3 Cir. 1943), 136 F. 2d 449, 31 AFTR 180; *Big Wolf Corp.*, 2 T.C. 751 (1943).

[9] Reg. 118, § 39.22(a)-8. (Under 1939 IRC)

[10] *Kraus* v. *Commissioner* (2 Cir. 1937), 88 F. 2d 616, 19 AFTR 174.

[11] *Holmes* v. *Commissioner* (3 Cir. 1943), 134 F. 2d 219, 30 AFTR 1103; *Rule* v. *Commissioner* (10 Cir. 1942), 127 F. 2d 979, 29 AFTR 462.

[12] *Miller* v. *Commissioner* (2 Cir. 1935), 80 F. 2d 219, 16 AFTR 1395. But see *Helvering* v. *Rankin*, 295 U.S. 123, 15 AFTR 1076 (1935); *Snyder* v. *Commissioner*, 295 U.S. 134, 15 AFTR 1081 (1935); *Curtis* v. *Helvering* (2 Cir. 1939), 101 F. 2d 40, 22 AFTR 416.

[13] *Davidson* v. *Commissioner*, 305 U.S. 44, 21 AFTR 960 (1938); *Smith* v. *Higgins* (2 Cir. 1939), 102 F. 2d 456, 22 AFTR 888, reversed on other grounds, 308 U.S. 473, 23 AFTR 800.

[14] Unless actual identification is possible, as in *Bloch* v. *Commissioner* (9 Cir. 1945), 148 F. 2d 452, 33 AFTR 955.

[15] *Commissioner* v. *Von Gunten* (6 Cir. 1935), 76 F. 2d 670, 15 AFTR 1206; *Commissioner* v. *Oliver* (3 Cir. 1935), 78 F. 2d 561, 16 AFTR 425; *Commissioner* v. *Bolender* (7 Cir. 1936), 82 F. 2d 591, 17 AFTR 677; *Fleischmann*, 40 B.T.A. 672 (1939). Averaging has also been applied to a reorganization of a single company, as in *Crespi* v. *Commissioner* (5 Cir. 1942), 126 F. 2d 699, 28 AFTR 1499.

[16] *Runkle*, 39 B.T.A. 458 (1939), remanded (6 Cir. 1941) 117 F. 2d 1014; 26 AFTR 492. See *Epstein*, 36 B.T.A. 109 (1937); *Hudson*, 39 B.T.A. 1075 (1939).

[17] In year-end transactions, it has been held that where a loss is involved, it occurs in the year of the execution date, *Ruml* v. *Commissioner* (2 Cir. 1936), 83 F. 2d 257, 17 AFTR 958; *Commissioner* v. *Robinson* (6 Cir. 1939), 103 F. 2d 1009, 22 AFTR 1169, whereas, in the case of a cash basis taxpayer, a gain occurs in the year of the settlement date, *Cedar Finance Co.* (1941), par. 41,361 Prentice-Hall Memorandum B.T.A.; *Taylor*, 43 B.T.A. 563 (1941), affirmed (2 Cir. 1942) 128 F. 2d 885, 29 AFTR 741. Thus, the holding period might end in a year

Stock dividends and rights. Some stock dividends are taxable and some are not.[18] If the dividend is taxable, the basis of the new stock is its value on the date of receipt. The holding period begins on the same date. On the other hand, if the dividend is nontaxable, its basis is an allocable part of the cost basis of the original stock.[19] In that event, the holding period for new stock is identical to that for the old stock.

The same is true of stock rights. If the right is to buy stock that, if distributed as a dividend, would be taxable, the basis of the right is its value on the date of distribution and the holding period begins then. The basis of a right to buy stock, the distribution of which would be nontaxable, is an allocable portion of the basis of the old stock. The holding period goes back to the date of acquisition of such stock.

The holding period for stock acquired on the exercise of a right begins as of the date of exercise, even though the right itself may have had a different basis and a different holding period.[20]

Somewhat similar principles apply to stock acquired on a "when issued" basis.[21] The purchaser receives a form of right to receive stock. If the stock is being issued pursuant to a tax-free transaction, the basis and holding period for the right go back to the date of acquisition of the old stock. Otherwise, the date of issue of the right would prevail.

Short sales. A short sale is a transaction in which the taxpayer, in effect, borrows securities, sells them, and then has an obligation to deliver similar securities to the lender at a later date. Prior to the Revenue Act of 1950, if the taxpayer owned securities he had held less than six months and wished to sell them in a long-term transaction, he could execute a short sale and cover it with his own securities after the six months' period had elapsed. Since, from a tax standpoint, a short sale was not regarded as complete until the covering securities had been delivered to the lender[22] and since the holding period began on the date of acquisition of the securities actually delivered,[23] the taxpayer could "lengthen" the holding period of his own securities.

This use of the short sale to convert short-term capital gains into long-term capital gains has been effectively eliminated by the Revenue Act of 1950.[24] Under the new law wherever securities "substantially identical" to those sold short have been held by the taxpayer for six months or less, or are acquired after the short sale but before the short sale is closed, any gain upon the closing of the short sale must be treated as a short-term capital gain, irrespective of the time when the securities actually used to close the short sale were acquired.[25] This means that

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different from the year of the gain. The distinction is, of course, absurd from a practical standpoint.

[18] See 1954 IRC § 305; 1939 IRC § 115(f) and Reg. 111, § 29.115-7.

[19] 1954 IRC § 307; 1939 IRC § 113(a)(19); Reg. 118, § 39.113(a)(19)-1.

[20] 1954 IRC § 1223(6); 1939 IRC § 117(h)(6).

[21] See I.T. 3721, 1945 C.B. 164.

[22] *Richardson* v. *Commissioner* (2 Cir. 1941), 121 F. 2d 1, 27 AFTR 610, cert. den. 314 U.S. 684.

[23] Reg. 118, § 39.117(h)-1.

[24] Revenue Act of 1950, § 211; 1954 IRC § 1233(b), 1939 IRC § 117(l).

[25] The holding period of the "substantially identical" securities is considered to begin when the short sale is closed, or when the securities are sold or otherwise transferred, whichever occurs first.

if a purchase of securities is offset within six months by a short sale of "substantially identical" securities, the taxpayer may not realize a long-term gain on the short sale, even though both positions are kept open for more than six months. On the other hand, wherever securities "substantially identical" to those sold short have been held for more than six months, any loss upon the closing of the short sale must be treated as a long-term capital loss, irrespective of the time when the securities actually used to close the short sale were acquired.[26]

"Wash sales." A former tax "dodge," now forestalled by the statute,[27] consisted of selling securities at a loss and shortly thereafter, buying similar securities to replace them. This often resulted in a tax loss without substantial change in the taxpayer's economic position. This transaction is known as a "wash sale." Such losses are disallowed if the repurchase occurs within 30 days before or 30 days after the sale. The holding period for the repurchased shares is the same as for the shares that were sold.[28] The "wash sale" provisions do not apply to a sale at a gain.

4. How Exchanges of Property Affect the Holding Period

An ordinary exchange of property for other property of a different kind has the same tax consequences as a sale. The taxpayer's gain or loss is the difference between his cost basis for the property he exchanges and the fair market value of the property he receives. Thereafter, the cost basis of the new property is its value on the date of the exchange. The holding period for the new property, therefore, begins on the day after the exchange.

On the other hand, there are many transactions in which, because of specific statutory provisions, no gain or loss is recognized on the exchange.[29] They include exchanges of identical or similar properties, corporate reorganizations, liquidations of corporate subsidiaries and certain other transactions. These are generally referred to as "tax-free" exchanges.

The basis of stock or other property which is received tax-free on such an exchange has as its cost basis the same basis as the stock or property which was given up on the exchange.[30] Therefore, the holding period goes back to the date on which the basis for the old property arose.[31] This is true only if the old property also qualified as a "capital asset." [32]

Usually, in these transactions, stock and similar securities are permitted to be received tax-free, while money and other types of property are taxable. The cost basis of property that is not received tax-free is its fair market value on the date of the exchange, and its holding period begins at that time.

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[26] Where a non-capital asset is involved, the short sale provisions apply only if the property used to close the sale is a capital asset in the taxpayer's hands. 1954 IRC § 1233(a).

[27] 1954 IRC § 1091; 1939 IRC § 118.

[28] 1954 IRC § 1223(4); 1939 IRC § 117(h)(4).

[29] 1954 IRC §§ 332, 351, 354, 355, 356, 361, 1031 and 1036; 1939 IRC § 112.

[30] 1954 IRC § 358 and 1031(d); 1939 IRC 113(a)(6).

[31] 1954 IRC 1223; 1939 IRC § 117(h)(1).

[32] Prior to the 1954 Code, the holding period was carried back even when the old property was not a "capital asset." *Gracey* 5 T.C. 296 (1945), affirmed (5 Cir. 1947) 159 F. 2d 324, 35 AFTR 680.

5. The Problems of Replacing Lost, Destroyed, or Seized Property

When property is destroyed, stolen, seized or condemned and the taxpayer receives insurance money or an award to compensate him for the loss, the transaction is described for income tax purposes as an "involuntary conversion." Under certain circumstances, if the entire insurance proceeds or other compensation are used to replace the lost property, the taxpayer may treat the transaction as tax-free. Any excess not used for replacement is taxable as a gain.

If the replacement occurs after 1950, the basis of the new property is its cost reduced by the amount of gain not recognized.[33] The holding period therefore begins on the date of acquisition of the new property.

A different rule applied to replacements made in 1950 or before. In such cases, the new property had the same basis as the old decreased by the amount not used for replacement, thus carrying the holding period back to the date of acquisition of the old property.

Involuntary conversions of the taxpayer's personal residence occurring on or after January 1, 1954 are treated in the same manner as other property as regards basis and the holding period, although different rules apply with respect to transactions occurring prior to that date.[34]

6. The Holding Period of Residential Property

When a man moves out of his home and rents it to others, he has converted it to a business use. If he later sells it at a loss, his basis is his actual cost, or the value of the property on the date of conversion, whichever is lower. Even if the conversion date is used, the holding period goes back to the date of actual acquisition.[35] This is an exception to the general rule that the holding period begins on the same date as the basis.

A taxpayer may sell his residence tax free if he buys or builds another within a specified time.[36] The holding period of the new residence in such a case goes back to the date of acquisition of the old one.[37]

7. When Corporations Are Treated Differently from Individuals

The holding period rules applicable to corporations are generally the same as in the case of individuals. Some of the property of a corporation is received by it as a contribution to capital or in exchange for its controlling stock. Such transactions are tax-free[38] and the basis of the property in the hands of the corporation is the same as its basis in the hands of the stockholders prior to the transfer. Therefore, the holding period goes back to the time of acquisition of the property by the stockholder.

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[33] 1954 IRC § 1033(c).
[34] 1954 IRC § 1033(b) and (c) and § 1034(i).
[35] Kimbell, 41 B.T.A. 940 (1940); I.T. 3041, 1937-1 C.B. 148.
[36] 1954 IRC § 1034(a); 1939 IRC § 112(n).
[37] 1954 IRC § 1223(7); 1939 IRC § 117(h)(7).
[38] 1954 IRC § 351; 1939 IRC § 112(b)(5).

Where a corporation receives property through a transaction that is not tax free, its basis is the cost or fair market value of the property at the date of acquisition. The holding period, of course, begins at the time of acquisition in such cases.

8. What Are the Partnership's Problems?

When a partnership is organized, the partners transfer property to it without gain or loss. The partnership holds the property at the same basis it had in the hands of the transferors, with the holding period going back to the time of the partner's acquisition.[39]

Likewise, when the partnership distributes property to the partners, they hold it at the basis it had in the hands of the partnership. This basis might go back to the taxpayer's own basis or, perhaps, to the basis in the hands of other partners. The holding period goes back to the time of origin of the basis.[40]

A complication arises in a case where the partnership is converted into a corporation. If the partnership assets are distributed to the partners, who then transfer them to the corporation in exchange for its stock, the holding period for the stock in the hands of the partners is measured from the date of acquisition by the partnership of the assets in question.[41]

On the other hand, in a case where the partners transferred their partnership interests to the corporation, it was held that the holding period for the stock in the hands of the partners went back to the date of acquisition of the partnership interests themselves, despite the fact that some of the assets had been held by the partnership for a shorter period of time.[42] The distinction between these two situations is so tenuous from a practical standpoint that it might not be safe to lean too heavily upon it. However, it does present a possible means of extending the holding period in such a case.

9. How to Treat Property Acquired by Inheritance

There was a time when the basis of property received on the death of a decedent depended upon the manner in which it was disposed of under the decedent's will. This gave rise to many troublesome complications. Now, however, the rule is very simple. The basis is the fair market value of the property at the time of the decedent's death.[43] Ordinarily, this is the value established in the Federal estate tax return. Thus, any appreciation or depreciation in value which occurred between the time the decedent acquired the property and the date of death goes out of existence as far as income tax is concerned.

Where the beneficiary is a vested or contingent remainderman who receives the property after termination of a life estate or some other interest created by will, the beneficiary's basis is the value on the date of the testator's death. This is in view of the fact that his interest came into existence through the death of the testator, even though enjoyment of the interest is postponed. The holding period also begins on the date of death.[44]

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[39] 1954 IRC § 721, 723 and 1223(2); 1939 IRC § 117(h)(2).

[40] 1954 IRC § 735(b) and § 1223(2). Inventory property is treated differently, however.

[41] *Kessler* v. *U.S.* (3 Cir. 1941), 124 F. 2d 152, 28 AFTR 620.

[42] *Thornley* v. *Commissioner* (3 Cir. 1941), 147 F. 2d 416, 33 AFTR 684. But see *City Bank Farmers Trust Co.*, v. *U.S.*, 47 F. Supp. 98, 30 AFTR (Ct. Cls., 1942).

[43] 1954 IRC 1014; 1939 IRC § 113(a)(5); *Brewster* v. *Gage*, 280 U.S. 327, 8 AFTR 10263 (1930). Except where the optional valuation date is used under IRC § 811(j). In that case, the optional value is used.

Use of the optional valuation date under Section 2032 does not affect the holding period, which still begins at the date of death, even though the optional value has to be used as the basis. This is one of the exceptions to the basic rule that the holding period follows the basis.

There have been several attempts by the Treasury to change the simple and workable rule now in effect. But so far Congress has not seen fit to restore the complications of the former law. The Treasury did succeed, however, in one small step in that direction in the case of jointly held property which passes to the survivor on the death of one joint owner. Logically, the survivor should hold one-half at his own basis and the other half at its value at the death of the decedent. However, it was held that the survivor retains the original basis for the entire property. This is based on the theory that the survivor received nothing from the decedent. All that happened was that the decedent's interest went out of existence.[45] Presumably, the holding period also dates back to the original basis.

However, the basis rule for surviving joint tenants was changed by the 1954 Code. The present rule in the case of decedent's dying on or after January 1, 1954, is that the basis of the survivor's entire interest is the fair market value of the property on the date of the decedent's death.[46] The holding period also starts as of that date.

10. How to Treat Gifts

In any case where the basis of property is the same as the basis in the hands of any other person, the holding period includes the time during which the property was held by such person.[47] Property acquired by gift is an example. If the gift was made after 1920, the basis of the property in the hands of the donee is the same as the donor's basis,[48] except that where there is a loss, the donee's basis may not exceed the value of the property on the date of the gift.

In any case where the donor's basis is used, the holding period goes back to the date of acquisition by him.

11. How Trusts Treat Their Property

Trustees who receive property by gift from a donor under an *inter vivos* trust hold the property at the same basis as in the case of other gifts, that is, the cost to the donor or the value on the date of gift, depending on the time of acquisition and whether a gain or loss is involved.[49] The holding period goes back to the basis. Property that trustees receive under the will of a decedent has as its basis the value of the property at the time of the decedent's death or the optional valuation, whichever is used. The holding period begins on the date of death.

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[44] *Helvering* v. *Gambrill*, 313 U.S. 11, 25 AFTR 1126 (1941).

[45] I.T. 3754, 1945 C.B. 143; I.T. 3785, 1946-1 C.B. 98.

[46] 1954 IRC § 1014(b)(9).

[47] 1954 IRC § 1223(2); 1939 IRC § 117(h)(2).

[48] Where the gift occurred before 1921, the value on the date of gift is used.

[49] See discussion of gifts above at section 10.

Property purchased by the trustees during administration of the trust has a basis equal to its cost to the trustees with the holding period starting at the time of purchase.

When the trustees distribute the trust estate to the beneficiaries, they receive it at the same basis and with the same holding period as it had in the hands of the trustees.

From a tax standpoint, a revocable trust is treated as nonexistent. Therefore, the trust assets have the same basis as they had in the donor's hands. When the donor dies, all assets of the trust immediately acquire a new basis, namely, the value on the date of death (or the optional valuation). The holding period, likewise, begins as of the date of death.[50]

Where a will provides for a trust to be established in a specified sum of money, and the executors transfer securities from the estate to serve as the principal of the trust, the transaction is treated as a sale of the assets to the trustees. The trustees hold the assets at their fair market value on the date of the transfer, and the holding period begins at the same time.

12. How to Handle Inventions and Created Property

The holding period for an invention and for a patent covering the invention has been held to be the date on which the inventor actually puts his invention into practice,[51] or the date of issue of the patent if such issuance occurs before the invention is put into practice.[52] The principle applicable to an invention would also govern other created property, such as a trade name or trademark.

13. How to Handle Sale of Installment Obligations

When property is sold on the installment basis, the seller may, by satisfying certain provisions of the Code,[53] report his gain or loss proportionately as the installments are received. The holding period is the period between the date of his original acquisition and the date of the installment sale.

If the seller later sells the notes or other installment obligations, he has a gain or loss equal to the difference between the amount he receives and the cost basis of the obligation as computed under the installment sale provisions.[54] The holding period for the obligation goes back to the original date of acquisition of the property sold.[55] The reason for this is that the seller's gain on the original sale has not been fully reported and the proceeds of the sale of the installment obligation are, in effect, a payment on account of the sale price of the property itself.

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[50] See *Fifth Avenue Bank* v. *U.S.*, 41 F. Supp. 428, 28 AFTR 491 (Ct. Cls., 1941), cert. den. 315 U.S. 820.

[51] *Myers*, 6 T.C. 258 (1946); *Diescher*, 36 B.T.A. 732 (1937).

[52] Bureau Letter, January 6, 1944, 433 C.C.H. par. 6267.

[53] 1954 IRC § 453; 1939 IRC § 44.

[54] 1954 IRC § 453(d); 1939 IRC § 44(d).

[55] See *Rogers Estate* 1 T.C. 629 (1943), affirmed (2 Cir. 1944) 143 F. 2d 695, 32 AFTR 1049, cert. den. 323 U.S. 780.

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How to Value Property

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2. When Valuations are Required

Valuation is a practical problem which arises in a variety of tax situations[1] under the Internal Revenue Code of 1954. It confronts a stockholder who desires to fix a fair price for his stock in a restrictive stock agreement.[2] It assumes serious aspects when its impact is measured in a substantial amount of estate taxes.[3] It establishes a basis for determining gain or loss for computing income tax on the sale of property. Frequently, it is the deciding factor in effecting a sale. It is also the statutory basis for computing gift tax[4] and other levies.

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[1] For a general discussion of the value concept and exhaustive reference to tax and nontax decisions, see James C. Bonbright, *Valuation of Property*, 2 volumes, New York: McGraw-Hill Book Co., Inc., 1937.

Tax planning for income, estate and gift taxes has been beset by many valuation difficulties. A low valuation for the purpose of one tax may bring, in consequence, a higher increment subject to another greater tax. And a low value of assets for the estate tax will result in a disadvantage—an enhanced income tax on subsequent sale. Indeed, in the same transaction a seller may seek a low value of assets, whereas the buyer will insist on the benefit accruing from assigning a higher value to the depreciable property.

With values constantly changing in successive periods of depression and inflation, the concept of fair value is admittedly elusive and difficult to identify. Despite the inherent difficulty, an estate tax valuation must be made. Only in extraordinary cases does property have no fair market value, and the Treasury always will find a figure of value for tax purposes.

Common Transactions Requiring Valuation

1954 Code Sections	
61-63	Gross income, adjusted gross income and taxable income
101-120	Items excluded from gross income
161-175	Allowance of deductions
261-273	Items not deductible
301-307	Distributions by corporations
311-312	Taxability of corporation distribution
331-338	Corporate liquidations
341	Collapsible corporations
351-395	Corporate organizations and reorganizations
401-421	Employee Pension, Profit-Sharing, Stock Bonus Plans
441-454	Accounting periods and methods of accounting
641-691	Taxable income of estates and trusts
701-761	Partners and partnerships
1001-1091	Gain or loss on disposition of property
1201-1241	Capital gains and losses
1321	Lifo inventories
1331-1337	War loss recoveries
2001-2033	Estate Tax
2501-2523	Gift Tax

3. What is Value?

The problems confronting the taxpayer who is involved in a valuation proceeding are: (1) what is the substantive connotation of the term value as applied to the facts in the pending case? (2) what method of measuring such value should be applied to obtain the maximum tax advantages?

The purpose for which property is evaluated is important, since the method adopted must be effective to serve that purpose. Generally, in estate and gift tax cases the end sought is to establish a standard to transmute property into an equivalent amount of dollars. We then apply certain recognized procedures and established techniques for valuing specific classes of tangible and intangible property.

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[2] See note 31.

[3] 1954 IRC § 2001, Reg. 105, § 81.10(a), 81.11.

[4] 1954 IRC § 2501.

Definition of value. There is no precise, all-inclusive definition of value. The judicial definition of the term is that price at which property will sell in the prevailing market, without a forced sale, between willing buyers and sellers, both having reasonable knowledge of the property and the market therefor.[5] This is generally known as the willing buyer and willing seller test and has been accepted by the courts and adopted in the Bureau's Regulations and rulings.[6] Value is a word of many meanings, and over the years its exact dimensions have not been stated. It is commonly expressed in terms of the dollars equivalent to the estimated worth of the specific property.[7]

The statute itself does not define the term "value." In the absence of a statutory definition in the Code, value in tax cases is considered synonymous with fair market value.[8] Where there is an active market of willing buyers and sellers, the actual prices paid are controlling on value. Difficulty most frequently arises where there is no real market, or where the market is abnormal, depressed or inflated. In such instances, a hypothetical standard must be substituted and applied, namely, what would the property have fetched if there were an existing normal market at the date of appraisal. The Bureau will ordinarily find a figure representing the fair and reasonable value for a specific item of property.

4. What Is the Best Method?

The process of estimating the worth or value of the particular property at a given date is essentially a factual problem. Finding market value is a fact to be determined from all of the relevant proof and environing circumstances known at the date of valuation.[9] Each valuation must be determined individually because the circumstances of each case will vary. It calls for judgment, experience and reason on the part of the trier of facts.

Various well-established methods and approaches are commonly used in the trial of a tax case. In most instances, the amount in controversy may be so small that it does not warrant a court trial and supporting testimony of qualified experts. In litigated valuation cases, professional appraisers who are skilled in evaluating particular types of property must be relied on. Considerable weight is usually accorded opinion evidence of an expert appraiser. The appraiser usually begins where the accountant leaves off, as their functions are entirely different. The former seeks to determine a value of particular property on the applicable valuation date. He will carefully select, weigh and measure many factors in the scale according to his professional judgment. Sometimes he will give most weight to assets, and at other times to the earnings and dividends in valuing shares of stock. The end result will ordinarily be an approximation, an expert's opinion as to worth. The appraiser will not estimate value with mathematical accuracy, because valuation is not regarded as an exact science. The existing techniques represent the methods accepted as reasonable under various combinations of factors, and have been found by experience to provide the primary means of establishing tax value.

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[5] "Value for tax purpose is a fact to be determined from evidence known at the date of valuation," *Zanuck* v. *Commissioner* (9 Cir. 1945), 149 F. 2d 714, AFTR 1448; *Phillips* v. *U.S.* (3 Cir. 1926), 12 F. 2d 598, 5 AFTR 5974; *Commissioner* v. *Marshall* (2 Cir. 1942), 125 F. 2d 943, 28 AFTR 1186; *Andrews* v. *Commissioner* (2 Cir. 1943), 135 F. 2d 314, 30 AFTR 1437; *James Couzens*, 11 B.T.A. 1040 (1928).

[6] Reg. 105, § 81.10(a), 81.11 (1940), *O'Malley* v. *Ames* (8 Cir. 1952), 197 F. 2d 256; Rev. Ruling 54-77, IRB 1954-9.

[7] *Great Northern Rwy.* v. *Weeks* (1936), 297 U.S. 135, 145.

[8] *Cecil H. Gamble*, 33 B.T.A. 94 (1935), affirmed (6 Cir. 1939) 101 F. 2d 565.

[9] *Colonial Fabrics Inc.* v. *Commissioner* (2 Cir. 1953), 202 F. 2d 105; *Guggenheim* v. *Commissioner* (2 Cir. 1941), 117 F. 2d 469, 26 AFTR 428, cert. den. (1941) 314 U.S. 621, *Elmhurst Cemetery Co.* v. *Commissioner*, 300 U.S. 37 (1937); *Seaside Improvement Co.* v. *Commissioner*, 105 F. 2d 990 (1939); *Wells Fargo Bank & Trust Co.* v. *U.S.* (D.Ct. 1953), 115 F. Supp. 655.

Since the various criteria considered in a particular case cannot be assigned mathematical weights, taking an average thereof to derive the fair market value is an improper procedure.

The inherent complexity of the problem of valuation must be recognized. The basic principles of the law of valuation have not changed, and recent decisions are merely cumulative. However, the facts constantly change. Procedurally, the official determination by the Director's Examining Agent is prima facie correct; the burden is on the taxpayer to prove it is erroneous.

How to arrive at a value must be considered in terms of the method and technique best suited for specific types of property. There is no single method or formula applicable to all classes of property. In the case of listed securities traded on an active market, the most workable hypothesis is to find a fair cash equivalent for what is being valued. How much money would it cost to replace the particular securities with comparable ones? A parallel market approach may be utilized in the case of various other items of property.

The following table presents a summary of the more commonly accepted methods:

Method	*Points to Remember*
Book value[10] (Reflects original cost, less depreciation of assets.)	Standing alone, cost of acquisition at a prior date has little weight. Regard is given to value of assets for March 1, 1913, basis. Cost not remote from value date is accepted.
Replacement cost	For fixed assets, residential buildings and mineral properties, which do not fluctuate. Net asset value is a proper factor where it is more certain than other criteria. Reproductive appraisals will be accepted if the aggregate value is equivalent to fair value of separate units, less accrued depreciation.
Sales price[11]	Arm's length and representative transactions in

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[10] Book value is of little weight in determining value, but book entries will be considered. *Nigel L. Campbell*, 1 B.T.A. 441 (1924); *Schuh Trading Co.* v. *Commissioner* (7 Cir. 1938), 95 F. 2d 404; *Ketler* v. *Commissioner* (7 Cir. 1952), 196 F. 2d 822; Estate of Frank M. Gould, 14 T.C. 414; *Publicker* v. *Commissioner* (3 Cir. 1953), 206 F. 2d 250.

[11] "Whatever property is worth for purposes of sale, it is worth for purposes of taxation," *H. R. DeMilt Company*, 7 B.T.A. 7 (1927); *H. H. Kuchman*, 18 T.C. 154 (1952). *Estate E. W. Hunt* 11 T.C. 984 (1948); *Maltine Co.* 5 T.C. 1265, (1945); *South Alabama Land Co.* v. *Commissioner*, 104 F. 2d 27 (1930); *Difco Laboratories, Inc.*, 10 T.C. 660.

Method	*Points to Remember*
	the market of a substantial amount of the same property constitute the best evidence. Offers to buy are unacceptable if unrelated to actual sales prices.
Earning capacity[12]	In absence of sales, what the property will normally earn is a reliable standard and the best measure of value. Establish normal earning capacity, and capitalize at appropriate rate. (See further discussion of the application of this method under unlisted common stocks. See Sec. 6(b) herein.)
Liquidating value	Not applicable to a going concern. Related to asset value as realized on a liquidation, or as scrap value.
Estate tax appraisals	Federal estate tax and probate court determinations are deemed to be prima facie evidence of the fair market value. For income tax basis, the value reported and accepted for Estate Tax controls.

In applying the foregoing various methods for determining value, consideration must be given to the data used. Only those facts which have been recorded, analyzed, and classified according to some predetermined plan are helpful. A miscellany of isolated, disorganized and uninterpreted facts should not be relied upon until they are arranged to tell a story. For example, comparative sales price data showing sales of similar property in arm's length transactions constitute the best evidence of value and reflect the existing market between willing sellers and buyers. Such data must be properly presented by eliminating irrelevant sales of non-comparable properties, supported by proof of the representative character of the sales.

5. How to Value Specific Classes of Property

a. Real estate. The factors to be considered are land, building, and improvements.[13]

1. *Value of land.* There is considerable literature on how land is valued by real estate appraisers, usually for local real property taxes. For income and estate tax purposes, the value of land is established by sales of similar realty or by local assessment officials and will generally be accepted. Where a controversy over substantial amounts exists, expert opinion will develop the bases of value from the following:—Location and geographical positions, relation to use for business or residence, size and shape of plot, existence of zoning and other restrictions. Plot-

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[12] *Consolidated Rock Products Co.* v. *DuBois* (1941), 312 U.S. 510, 525, 34 AFTR 380; *Palmer* v. *Conn. R.R. Co.* (1941) 311 U.S. 544; *Galveston Ry. Co.* v. *Texas*, 210 U.S. 217, 226; *Ithaca Trust Co.* v. *U.S.*, 279 U.S. 151, 7 AFTR 8856; *Manufacturers Paper Co.* v. *Commissioner*, 89 F. 2d 684 (1937); *Estate of Guebriant*, 14 T.C. 611; *Goss* v. *Fitzpatrick* (D.Ct. 1951) 97 F. Supp. 765.

[13] Alex M. Hamburg, "Valuation of Real Property for Taxation," *Taxes*, Vol. 17, page 139; Stanley L. McMichael, *Appraising Manual*, 4 ed. New York: Prentice-Hall, 1951; Frederick M. Babcock, *Valuation of Real Estate.* New York: McGraw-Hill Book Co., 1933. *Meaker Co. Inc.*, 16 T.C. 1348.

tage and other increments will add to value. Thus, a corner lot is generally worth more than an irregular or inside plot. Unit values are used such as 25′ x 100′. This is a relevant standard against which is measured by use of tables and formulae lots which have greater or less value. Industrial and commercial sites require appraisal by experts experienced in this specialized work.

2. *Value of buildings.* Pertinent data should be compiled by an expert real estate appraiser to show (1) the sales price of comparable improved real estate, (2) the replacement cost, (3) earning capacity of the property. In the case of business property, (a) the capitalization of fair rentals (earnings), and (b) comparison value are the methods commonly used; in residential property weight is given to reproduction cost less depreciation. The earnings method also covers office buildings, hotels, apartment property, so-called business "taxpayers" and like commercial buildings. Sales prices of similar or adjacent property furnish the best comparative evidence of market value. Bids without supporting proof will have no bearing on value. Improved real property should be valued as a unit, not as the aggregate of the separate values of land and building. An undivided minority interest has been valued by allowing a 15 per cent discount from the pro rata fair value.[14]

b. Leaseholds.[15] The same considerations are relevant here as in valuing income-producing real estate. Special elements such as the existence of a renewal privilege, the length of term of tenancy are also significant. Department stores, theatres, office buildings are among the various types of leaseholds which have been valued in the decided tax cases.[16]

c. Mortgages. The value of the underlying real estate or other property is usually the most important factor. Where a discount from full value is sought, the Bureau requires the following data:—assessed value of the fee; current annual rentals; gross and net income; the interest paid; arrears in interest or taxes; prior mortgages and liens; history-foreclosures or assignments; unpaid balances, and other similar facts.[17]

d. Bonds and promissory notes. The current market price of bonds on an exchange is the best evidence of their value. In the absence of such market prices, the burden of proving a value less than face value rests on the taxpayer. Among the factors entitled to weight are:—solvency and financial status of the debtor; any refusal of banks to discount such paper; lack of salability or negotiability at face value.[18]

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[14] A valuation of citrus groves was considered in *Carlton* v. *Commissioner* (5 Cir. 1951), 190 F. 2d 183, *Estate of C. S. Herter*, T.C. Memo (Mar. 31, 1954); *Estate of S. H. Henry*, 4 T.C. 423 (1944), aff'd 161 F. (2) 574 (CA 3, 1947); *Estate of Henry Huntington*, 36 B.T.A. 698 (1937); *Meader* v. *U.S.* (1939), 26 F. Supp. 926, 26 AFTR 925 *Huron Bldg. Co.*, 15 B.T.A. 1107 (1929), affirmed (6 Cir. 1931) 53 F. 2d 575; *Doric Apartment Co.* v. *Commissioner*, 94 F. 2d 893 (1935); *Sterling Realty Co.*, 8 B.T.A. 1000; *Alexander H. Hunter*, 10 T.C.M. 298; *J. Roscoe Grace*, 12 B.T.A. 558.

[15] *Friend* v. *Commissioner* (7 Cir. 1939), 102 F. 2d 153, 22 AFTR 653; *Ralph H. Plumb*, 7 B.T.A. 295 (1927); *Oxford Paper Co.* v. *Commissioner*, 15 T.C. 361, rev'd. 194 F (2d) 190 (1952).

[16] *Hotel Waldorf Co.*, 22 B.T.A. 430 (1931); *719 Fifth Ave. Co.*, 5 B.T.A. 121 (1926); *Bonwit Teller & Co.* v. *Commissioner* (2 Cir. 1931), 53 F. 2d 381, 10 AFTR 656; *Harris Amusement Co.*, 15 B.T.A. 190 (1929).

[17] *Lehigh Building Corp.*, 7 B.T.A. 460 (1927); *Rosencrans*, T.C. Memo, Feb. 26, 1954.

[18] *Frischkorn Development Co.* (6 Cir. 1937), 30 B.T.A. 8, affirmed 88 F. 2d 1009, 19 AFTR 244; *National Tea Co.*, 17 B.T.A. 1222 (1929).

e. Accounts receivable. A taxpayer's adjustment for a reasonable reserve or allowance for bad debts will be accepted in the case of ordinary commercial accounts. The estimated realizable value will represent fair market value.[19] Since the difference between this and face value will ordinarily be made up in the subsequent income tax return, the item has been liberally treated in valuation cases.

f. Life insurance policies and annuity contracts.[20] Under estate and gift tax statutes decisions and regulations, value is established by the prices of comparable contracts if such policies are replaceable.

g. Cemetery lots. This is still an unsettled and difficult problem. The determining factors have been set forth in the decisions cited.[21]

h. Timber. Valuation of timber lands is required as of the beginning of the tax-year to establish fair market value for depletion, gain or loss, etc.[22]

i. Oil and mineral properties. Comprehensive provisions relating to the value of oil, gas, mineral and other natural resources have been enacted.[23] The values required as a basis for depletion and depreciation deductions call for appraisals by engineering and technical experts with specialized knowledge of the market and production.

j. Inventories. Generally, the methods of valuing merchandise inventories commonly used are:[24]

(1) Cost; or (2) cost or market, whichever is the lower. In certain industries, an elective method may be adopted: "at market" for dealers in securities; unit livestock price method for farmers; last-in first-out method, known as "Lifo," for those taxpayers who consistently match purchases with sales. In using "Lifo" the primary problem is the valuing of the closing inventory in terms of cost of the earlier purchases. Regulations and decisions interpreting the applicable statute should be consulted for detailed requirements which constitute exceptions to the general rule of cost.[25]

k. Preferred stock. Actual sales are regarded as the most important criterion in determining the value of this type of property. Par is the usual value. Absent market-sales price, a guide to its value is to be found in the price at which similar preferred stock with the same dividend and similar preferences has sold.[26] For patents, copyrights, trade-marks, and similar assets, see discussion of good-will, Section 7a of this chapter.

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[19] *Old Farmers Oil Co.*, 12 B.T.A. 203 (1928); *Coca-Cola Bottling Co.*, 22 B.T.A. 686 (1931).

[20] 1954 IRC § 72 and new Regulations. Reg. 105, § 81.10(1) *Mearkle's Estate* v. *Commissioner* (3 Cir. 1942), 129 F. 2d 386, 29 AFTR 913; *Estate of Welliver*, 8 T.C. 165 (1947); *Estate of Denbigh*, 7 T.C. 387 (1946).

[21] 1954 IRC § 501(c)13; *Elmhurst Cemetery Co.* v. *Commissioner* (1937), 300 U.S. 37, 18 AFTR 1130; *The Evergreens*, 47 B.T.A. 815 (1942), affirmed (2 Cir. 1944) 141 F. 2d 927, 32 AFTR 531; cert. den. (1944) 323 U.S. 720; *Seals*, 18 T.C. 1263, rev'd. (6 Cir. 1954) 211 F. 2d 133.

[22] 1954 IRC Sec. 631; *Ritter Lumber Co.*, 33 B.T.A. 117 (1935); *Tall Timber Lumber Co.*, 16 B.T.A. 300 (1929), affirmed (5 Cir. 1930) 39 F. 2d 888, 8 AFTR 10629.

[23] 1954 IRC Sec. 611-616; *W. O. Williams*, 16 B.T.A. 109 (1929), affirmed (5 Cir. 1930) 45 F. 2d 61; *Craig*, T.C. Memo, Nov. 30, 1949; Miller, Kenneth G., "Oil and Gas," *Federal Income Taxation*, Chicago, Commerce Clearing House, Inc. 1952; *Beck* v. *Commissioner*, 15 T.C. 642, aff'd (2 Cir. 1952) 194 F. 2d 537. Breeding, Clark W. and Burton, A. Gordon, *Taxation of Oil and Gas Income*; New York: Prentice-Hall, 1954. Sullivan, Robert E., *Handbook of Oil and Gas Law*; New York: Prentice-Hall, 1955.

[24] *Kelley* v. *U.S.* (Dist. Ct. Mass. 1939), 27 F. Supp. 570, 23 AFTR 470; *Bedford Mills* v. *U.S.* (75 Ct. Cls. 412) (1932), 59 F. 2d 263, 11 AFTR 443.

[25] 1954 IRC § 1321; cf. Reg. 111, § 29.22(d)-1.

6. How to Value Common Stocks

The two main classifications considered herein are listed and unlisted stocks.

a. Listed stocks. If there is an active market the best evidence of value will be representative sales on a stock exchange on or about the value date. It has been observed—"Courts will not lightly deviate from evidence based on actual sales." This criterion of value is controlling to the extent that it would take strong and convincing evidence or some other fact to justify a departure from it. Regulations prescribe the detailed procedure for evaluating stocks which are listed and for which an active market exists:[27]

1. Obtain the mean of high and low sales price or quotations on value date recorded on an exchange.
2. If no sales, pro-rate the difference between the mean of sales nearest to value date; that is, a reasonable period before and after such date.
3. If (2) not available then use bid and asked quotations similarly.
4. If sales or bid and asked prices only exist before value date, but none thereafter, use mean of prior sales or bid and asked prices.

When modifications of value are allowed. 1. *Blockage.*[28] To obtain the benefit of blockage, it must be proven that a large block of stock could not be sold or absorbed by the market at the price level for which a smaller number of shares were sold. This allowance has only been granted in a limited number of cases and must be proven in each case as a fact. Ordinarily, sales prices of listed stocks will govern the fixation of value. But the value of a large block of stock at the same figure obtainable for a small unit is often questionable. Hence the blockage rule. It is restricted to that discount that would be given on stock sold in a "secondary distribution"—that is, what a skillful stockbroker would expect to realize from liquidating the stock over a reasonable period on the most favorable terms. It is best not to rely on the blockage factor unless the differential is substantial and can be demonstrated factually.

2. *Abnormal conditions.*[29] Actual sales prices of stocks listed on an exchange have also been subject to modification upon a showing that such prices were not factually representative of a free market between willing buyers and sellers. Inflated boom conditions or an abnormally depressed or thin market may have

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[26] *Oxford Paper Co.* v. *U.S.* (1931), 52 F. 2d 1008, 10 AFTR 525; *Clements* v. *Commissioner* (8 Cir. 1937), 88 F. 2d 791, 19 AFTR 191.

[27] Reg. 111, § 29.113(a)14; *Estate of Spencer*, 5 T.C. 904 (1945); *Estate of McKitterick*, 42 B.T.A. 1390 (1940).

[28] *Mott* v. *Commissioner* (1943), 139 F. 2d 317, 31 AFTR 1067; *Havemeyer* v. *U.S.* (1945), 59 F. Supp. 537, 33 AFTR 1069; *Bull* v. *Smith* (2 Cir. 1941), 119 F. 2d 490, 27 AFTR 151; *V. B. Allen* (1944), 3 T.C. 1224 (1944), *Henry F. DuPont* (1943), 2 T.C. 246; *Helvering* v. *Maytag* (8 Cir. 1942), 125 F. (2d) 55.

[29] *Strong* v. *Rogers* (3 Cir. 1934), 72 F. 2d 455, 14 AFTR 468; *Crosby* v. *Heiner* (1926), 12 F. 2d 604, 5 AFTR 5980, affirmed (3 Cir. 1928) 24 F. 2d 191; *Estate of Howard Case* v. *U.S.* (1934), 15 AFTR 1011, *Matter of Behrens*, 61 N.Y.S. 2d 179, affirmed 271 App. Div. 1007 (1947).

prevailed at the value date. Such testimony will rebut the presumption that the Bureau's valuation based on market prices is a fair market price. Manipulation of stock prices and similar devices will also affect the use of market price as a controlling measure of value.

3. *Restrictions.* Where stock is subject to restrictive agreements or other covenants, this factor has been recognized as depressing its market value for Federal income, estate, and gift taxes.[30] If it appears the marketability of such restricted shares has been limited, and the valuation has been fixed by agreement, the option price may be determinative of the fair market value for taxation.[31]

b. Unlisted stocks: *Methods and approaches.* No single method is prescribed for valuing the shares of stock of a close corporation.[32] This term includes corporations whose shares are owned by a few stockholders or a small family group. Hence, there is seldom an established market or active trading in such shares. Sales which occur at irregular intervals do not "reflect all the elements of a representative transaction as defined by the term 'fair market value.' "[33]

In the absence of market quotations the Bureau's Regulations stress that all relevant factors should be considered including book value of the stock,[34] dividend prospects[35] and earnings.[36] The weight to be accorded to each factor will vary with the nature of the business. Thus, earnings may be the best criterion of value in cases involving the valuation of stocks of companies which sell products or services. Asset value may be the best yardstick to appraise the value of the underlying assets of a holding company. The latter approach applies to the stock of personal or family holding companies.

The recently published Bureau Ruling 54-77 has discussed in detail the approach, methods and factors to be considered in valuing the shares of stock of closely held corporations for estate and gift tax purposes. The extracts which follow are from the official ruling relating to this subject matter.[37]

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[30] *Helvering* v. *Salvage* (2 Cir. 1935), 76 F. 2d 112, 16 AFTR 1322, affirmed (1936) 297 U.S. 106; *Wilson* v. *Bowers* (2 Cir. 1932), 57 F. 2d 682, 11 AFTR 33; *Estate of Childs* (3 Cir. 1945), 147 F. 2d 368, 33 AFTR 676; *Lomb* v. *Sugden* (2 Cir. 1936), 82 F. 2d 166, 17 AFTR 582; *Armstrong* v. *Commissioner* (1945), 146 F. 2d 457, 33 AFTR 401; *Hoffman* v. *Commissioner* (9 Cir. 1945), 148 F. 2d 285, 26 AFTR 486.

[31] *Worcester County Trust Co.* v. *Commissioner* (1st Cir. 1943), 134 F. 2d 578; *Commissioner* v. *McCann* (2d Cir. 1944), 146 F. 2d 385; *Spitzer* v. *Commissioner*, 153 F. 2d 967; Forster, "Legal, Tax & Practical Problems under Sales Agreements," 19 *So. Calif. Law Review*; Rabkin, Jacob and Mark Johnson, "Current Legal Forms," *Tax Analysis*, 3.62, Matthew Bender & Co., New York 1948; Ness, Theodore, "Federal Estate Tax Consequences of Agreements and Options to Purchase Stock on Death," 49 *Col. L. Rev.* 796 (1949); O'Neil, "Stock Transfer Restrictions," 65 *Harv. L.R.* 786 (Mar. 1952).

[32] See: 1954 IRC § 851(c)4; Reg. 105, § 81.10(c); Reg. 108, § 86.19(c); Reg. 111, § 29.113(a) 14.

[33] Alex M. Hamburg, "Tax Valuation of Real Estate, Stock and Good Will," *Proceedings of New York University Sixth Annual Institute on Federal Taxation*, pages 145-162. New York: Matthew Bender Company, 1948.

[34] *Estate of Coulter*, 7 T.C. 1280 (1946); *Estate of Cruikshank*, 9 T.C. 162 (1947); *Estate of Bossak*, T.C. Memo. July 17, 1946; *Estate of Freed*, T.C. Memo., February 27, 1947; *James Couzens* (*supra*); *In re Nathan's Estate* (9 Cir. 1948), 166 F. 2d, 422.

[35] *James H. Schwacher*, T.C. Memo., Nov. 13, 1946; *Victoria L. Cotton*, T.C. Memo., affirmed (9 Cir. 1948) 165 F. 2d 987; *Merritt J. Corbett Estate*, 12 T.C. 163 (1949).

[36] *Mills & Co.*, T.C. Memo. (Aug. 19, 1946); *Estate H. T. Sloane* (1944) T.C. Memo., affirmed (2 Cir. 1945); *Spitzer*, T.C. Memo. (March 27, 1947); *Estate of Watson*, 7 T.C.M. 74 (1948); *Estate of Straus*, 8 T.C.M. 442 (1949); *Plaut* v. *Smith*, 82 F. Supp. 42 (1949) affirmed (2 Cir. 1951) 188 F. 2d 543; *Weber* v. *Rasquin*, 101 F. 2d 62 (1939).

[37] Rev. Ruling 54-77, 1954 I.R.B. 9, p. 17.

Factors to consider:

The following factors, although not all-inclusive, are fundamental and require careful analysis in each case:

(1) The nature of the business and the history of the enterprise, including the date of incorporation.

(2) The economic outlook in general and the condition and outcome of the specific industry in particular.

(3) The book value of the stock and the financial condition of the business.

(4) The earning capacity of the company.

(5) The dividend-paying capacity.

(6) Good-will.

(7) Sales of the Stock and the size of the block of stock to be valued.

(8) The market price of stocks of corporations engaged in the same or a similar line of business which are listed on an exchange.

(1) *The History of a Corporate Enterprise:*

> The history to be studied should include, but need not be limited to, the nature of the business, its products of services, its operating and investment assets, capital structure, plant facilities and management, all of which should be considered as of the date of the appraisal, with due regard for recent significant changes. Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy. . . .

(2) *Current and Prospective Economic Conditions:*

> Equal or even greater significance may attach to the ability of the industry with which the company is allied to compete with other industries. Prospective competition which has not been a factor in prior years should be given careful attention. The public's appraisal of the future prospects of competitive industries or of competitors within an industry may be indicated by price trends in the markets for commodities and for securities. The death of the manager of a so-called 'one-man' business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise.

(3) *Book Value:*

> Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit. Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by obtaining supplemental schedules. These statements usually will disclose to the appraiser, (1) liquid position (ratio of current assets to liabilities); (2) amount of net fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth. Consideration also should be given to any assets not essential to the operation of the business, such as investments in securities, real estate, etc. In general, such nonoperating assets will command a lower rate of return than do the operating assets, although in exceptional cases the reverse may be true. In computing the book value per share of stock, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly. Comparison of the company's balance sheets over several years may reveal, among other facts, such developments as the acquisition of additional production facilities or subsidiary companies, improvements in financial position, and details as to recapitalizations and other changes in the capital structure of the corporation.

(4) *Earning Capacity:*

> Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years. Such statements should show (1) gross income by principal items; (2) principal deductions from gross income including major items of operating expense, interest and other expense on each item of long-term debt, depreciation and depletion if such deductions are made, officers' salaries in total if they appear to be reasonable or in detail if they seem to be excessive, contributions (whether or not deductible for tax purposes) that the nature of its business and its community position require the corporation to make, and taxes by principal items, including income and excess-profits taxes; (3) net income available for dividends; (4) rates and amounts of dividends paid on each class of stock; (5) remaining amount carried to surplus; and (6) adjustments to, and reconciliation with, surplus as stated on the balance sheet. With profit and loss statements of this character available, the appraiser should be able to separate recurrent from nonrecurrent items of income and expense, to distinguish between operating income and investment income. . . . Prior earnings records usually are the most reliable guide as to future expectancy, but resort to arbitrary five- or ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power. It will be helpful, in judging risk and the extent to which a business is a marginal operator, to consider deductions from income and net income in terms of percentage sales. Major categories of cost and expense to be so analyzed include the consumption of raw materials and supplies in the case of manufacturers, processors and fabricators; the cost of purchased merchandise in the case of merchants; utility services; insurance; taxes; depletion or depreciation; and interest.

(5) *Dividend-Paying Capacity:*

> Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have any relation to dividend-paying capacity. Specifically, the dividends paid by a closely held family company may be measured by the incoming needs of the stockholders or by their desire to avoid taxes on dividend receipts, instead of by ability of the company to pay dividends. Where an actual or effective controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders. The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understating the dividend-paying capacity of the company. It follows, therefore, that dividends are less reliable criteria of fair market value than other applicable factors.

(6) *Good-will:*

> See discussion of the inclusion and valuation of this factor in Section 7 *infra.*

(7) *Sales of Stock:*

> Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value, nor do isolated sales in small amounts necessarily control as the measure of value. This is especially true in the valuation of a controlling interest in a corporation. Since, in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be

considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or effective, representing as it does an added element of value, may justify a higher value for a specific block of stock.

(8) *Comparative Stocks:*[38]

The Revenue Act of 1943 amended the Internal Revenue Code by adding subsection (k) of section 811, which states, in effect, that in valuing unlisted securities the value of listed stocks or securities of corporations engaged in the same or similar line of business should be taken into consideration. In selecting corporations for comparative purposes, care should be taken to use only truly comparable companies. For illustration, a corporation having one or more issues of preferred stock, bonds or debentures in addition to its common stock should not be considered comparable to one having only common stock outstanding. In like manner, a company with declining business and contracting markets is not comparable to one with a record of current progress and market expansion. The test should be for similarity not only of the type of business but of the trend of earnings, capital structure, volume of sales, and size in terms of total assets, as well, in order that the most valid comparison possible will be obtained.

The following summary indicates the use and weight to be accorded to each factor:[39]

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[38] 1954 IRC Sec. 2031(b) formerly Sec. 811(k) of the 1939 IRC: "Valuation of Unlisted Stock and Securities": "In the case of stock and securities of a corporation the value of which, by reason of their not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices or with reference to sales prices, the value thereof shall be determined taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange." Cf. Reg. 105, Sec. 81.10(c); *See Estate of L. F. Olney*, T.C. Memo. (1946); *Estate of W. C. Cherry*, T.C. Memo. (1946); *Estate of F. Webb*, T.C. Memo (1944). Roger K. Powell, "Estate Tax Valuation," *The Estate Tax Handbook* (1951) p. 369.

[39] In *Drayton Cochran* 7 T.C.M. 325 (1948), involving a valuation of the stock of a close corporation, the *Alexander Smith & Sons Carpet Company*, the following factors which were given consideration for gift and estate taxes in addition to net worth, dividend record, and earning capacity: (1) The position of the Company in the carpet and rug industry, (2) the competition in the industry (3) the characteristics and problems of the carpet and rug industry, such as fluctuations in the demand for its products, and the importance of raw materials and inventories. In this connection, they found that the carpet and rug industry is highly cyclical and among the first to suffer in a depression and to lag behind in the subsequent period of recovery, (4) the economic and business situation in the country in December, 1941, and during 1942, (5) the problem of raw materials which arose in the war period by reason of the fact that carpet class wool had to be imported, (6) the OPA and price limitations imposed upon the industry by the Government, (7) the limitations placed on the production of carpets and rugs during the war, (8) the gradual and involuntary liquidation of inventories by the company and the other members of its industry, (9) the declining sales of carpets and rugs during the war, (10) the necessity for conversion to war production, (11) the labor problems resulting from the war, (12) the company's disadvantageous position as regards war work, (13) the trend toward increased taxes, (14) the condition of the securities market, in December 1941 and during 1942, (15) the lack of marketability of the company's stock, (16) the minority interests represented by the stock to be valued, (17) the prospects of the company's future earnings, (18) the adverse effects of the war upon the industry as a whole, and upon the Smith Company particularly, (19) the various elements which enter into valuation of common stocks, such as book value on the critical base dates, and earnings per share, (20) yield, ratio of dividend income to cost of stock, (21) the past volume of sales, earnings, and dividends of the Smith Company in normal years and poor years, (22) the net worth of the company as adjusted, (23) the complete history of all sales of stock of the company during the ten year period, 1933 through 1942, (24) a comparison with the market prices at which the stocks of the company's competitors were selling at the valuation date, (25) a computation of the value of the Smith Company stock on the basis of the factors arrived at from the market values of the stock of its two competitors, adjusted for the lack of marketability of the Smith Company stock.

Method	*Use where:*
Book Value:	(a) cost of acquisition is not remote from value date; (b) tangible assets behind stock are substantial; (c) liquidation of underlying assets may be effected; (d) used only if earnings do not reflect fair value; (e) market value of the underlying assets can be determined.
Dividend Yield:	(a) dividend distributions are a small percentage of earnings; uniformly low pay-out helps to establish low value; (b) record of conservative, favorable policy over period of years is important; (c) large distributions must not have been by reason of Section 531 tax. The relation to earning power and going rate of interest is significant.
Normal Earnings:	(a) normal, prospective earning capacity is ordinarily controlling; it is the pivot on which value turns; (b) past average net earnings furnish an index of anticipated net income;—trend of earnings, stability and regularity are important; (c) select a representative period of at least five normal years; exclude war years. (d) abnormal items should be adjusted or eliminated to obtain "normal earning capacity"; (e) apply an appropriate rate of capitalization to earnings after Federal taxes;—the stable or speculative nature of the business will affect the choice of rate. The stock market itself should furnish a price-earnings radio. See subsection (g) *infra.* (f) if intangible assets contribute to earning power, excess earnings are capitalized for good-will value (Sec. 7); (g) supporting evidence of the sales of comparative listed stocks of the corporations in the same or similar lines of business. 1954 I.R. Code, Sec. 2031 (cf. Note 38)

7. How to Value Good-will and Intangibles

There are frequent occasions for evaluating intangible assets for Federal taxation. In valuing a decedent's business interest, the regulations require an appraisal of all the tangible and intangible assets, including good will.[40] In a sales contract of mixed assets for a lump sum, it is often desirable to assign a separate value for good will and establish a gain or loss basis. Usually, the difference between the price paid and the value allocated to tangible assets represents good will.[41] A first step is the proper identification and classification of intangibles for valuation.

a. Definition of good will. The conventional elements of good will are name and location. In recent years, this concept has been expanded so that now it embraces all those competitive advantages inherent in a going business beyond the value of the tangible assets employed. It is often the most valuable and dominating asset, particularly when favorable customer relations have been well established.

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[40] Reg. 105, § 81.10.

[41] *Williams* v. *McGowan* (2d Cir. 1945), 152 F. 2d 570; *Cohen* v. *Kelm* (D. Ct. Minn. 1954), 119 F. Supp. 376; *Estate of A. Bluestein,* 15 T.C. 770 (1950); V. *Newton,* 12 T.C. 204 (1949); *Clarence Whitman & Sons, Inc.,* 10 T.C. 264 (1948); *Grace Bros. Inc.,* 10 T.C. 158 (1948), affirmed (9 Cir. 1949) 173 F. 2d 170.

While good will is not susceptible of precise definition and is used interchangeably with intangible assets, it has some recognized distinct characteristics. It encompasses all favorable customer patronage elements, including trade name, trade marks, mail and newspaper circulation lists, franchises, salesmen's routes and similar items. Good-will has been referred to as "the likelihood that customers will return to the place of business." [42]

The judicial concept of good-will is commonly relied on in cases involving transfers of a business including its good-will. The transferee obtains the exclusive right to a trade name or brand. He can legally restrain the transferor from soliciting old customers and from competing in given areas.[43]

The accountant's concept of good will recognizes that a commercial enterprise may have excess value, i.e., a value over and above the aggregate value of the tangible property employed in it.[44] While the dividing line is not clearly marked, the items included under excess value usually embrace the residue of those advantages not related to specific tangible property or susceptible to separate valuation. Thus, managerial skill, good credit status, excellent labor supply, etc. The excess of the total value of the enterprise over the value allocated to specific assets represents a real but intangible value. For lack of a better name, it is equated with good will by professional accountants.[45]

Personal characteristics or specialized skill do not constitute good will. In many cases the problem has been to determine whether good will value was personal to the executives-owners of a business, and was incapable of being transferred.[46] In personal service partnerships, reputation and contacts are not considered of value apart from the assets employed therein. Considerable value has been allocated to the good will of a corporation by the Tax Court despite the claim such value was personal to the controlling owner of the business.[47] Although good will may not have been recorded on the books of account, it was found to exist.[48]

Good-will and other types of intangibles are a composite of complex and elusive components. Although it may be difficult to describe, good-will is nevertheless a valuable part of the over-all net worth of a business. Once it has been developed that it exists there are methods for measuring the excess value attributable to good will. These will next be considered.

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[42] *In re Brown's Will*, 242 N.Y. 1 (1926); Cf., Reg. 111, Sec. 29.33(a)-1; *R. H. Donnelley Corp.*, 26 B.T.A. 107 (1932); *X-Pando Corp.*, 7 T.C. 48 (1946).

[43] *Cassatt* v. *Commissioner* (3 Cir. 1943), 137 F. 2d 745; *R. S. Cozler*, 14 T.C. 1251 (1950); *Aaron Michaels*, 12 T.C. 17 (1949); *L. Heller & Son, Inc.*, 12 T.C. 1109 (1949); *H. E. Broadfoot*, T.C. Memo (1952); *Toledo Newspaper Co.*, 2 T.C. 294 (1943); *Seattle Brewing Co.*, 6 T.C. 856 (1946).

[44] Davis, "Good-Will and the Balance Sheet," 11 N.Y. *Certified Public Accountant*, 33 (1940); W. A. Paton, *Accountant's Handbook*, 844 (3rd Ed. 1952).

[45] *American Institute of Accountants, Accounting Trends & Techniques*, 55 (1951); Finney & Miller, *Principles of Accounting*, 496 (1951); Kester, *Advanced Accounting*, 353 (1946); Leuhart, "What is Good Will?" 91 *Jl. Accountancy*, 103 (1951).

[46] *Howard B. Lawton*, 6 T.C. 1093 (1946), revised (6 Cir. 1948), 164 F. 2d 381; *Floyd D. Akers*, 6 T.C. 693 (1946); *Rodney B. Horton*, 13 T.C. 143 (1939) (appeal dismissed), 180 F. 2d 354; *D. K. MacDonald*, 3 T.C. 720 (1944); *White & Wells Co.* v. *Commissioner*, 50 F. 2d 120.

[47] *John Q. Shunk* v. *Commissioner*, 10 T.C. 293 (1948) (6 Cir. 1949), 173 F. 2d 747.

[48] *Pflegher Hardware Specialty Co.* v. *Blair* (2 Cir. 1929), 130 F. 2d 614. For the Securities & Exchange Commission requirements, see 17 Code Fed. Regs. Sec. 210.5-02 (1952).

b. Valuation of good-will. Much is wanting by way of a reliable technique for determining intangible values. What is being valued is the earning power of the going business, namely, its demonstrated ability to earn profits over and above a fair return on the tangible assets employed. In the ordinary case, the accepted procedure is to capitalize the excess earning power. The average net earnings are capitalized at a fair rate of return, and the value arrived at is considered to be the total tangible and intangible value of the enterprise.[49] In state inheritance tax proceedings, the procedure usually followed is to allow a 6 per cent return on net worth and deduct this from average earnings; then to multiply the balance by three or five to arrive at the value of good-will. This is added to book value to determine the total value.[50]

The Treasury Department has consistently followed the income tax method as published in an early ruling, A.R.M. 34, which provides for the following arbitrary steps: (1) determine the average value of tangible assets; (2) determine the average annual net earnings of the business as a whole over the preceding 5 years; (3) deduct from such net earnings an amount representing a fair and reasonable return on the tangible assets; (4) capitalize the balance of excess earnings at an adequate rate to arrive at the value attributable to good will. Use of the 8 per cent return on tangibles and 15 per cent capitalization rate has been approved.[51]

A number of difficult problems arise in evaluating good will by the capitalization of earnings formula.[52] This mechanical approach fails to give proper realistic scope to the content of "tangibles" when the fixed assets are taken in at their book value. To arrive at normal average earnings it is essential also to eliminate earnings of abnormal years and other fortuitous earnings. Recent decisions indicate a period of at least five years is considered representative, and that abnormal years should be eliminated. Earnings of a period subsequent to the basic valuation date are excluded as hindsight, except for the limited purpose of corroboration. Similarly, outside earnings which are not directly attributable to a company's operation should be excluded.

In valuing good will and other intangibles, the earnings element is of major importance in the capitalization process. The figure determined for past earnings should be one which is a reliable guide in estimating future normal earning capacity. Inquiry should, therefore, be made into all the financial and operating factors which are relevant to the past, present and prospective level of earnings of the business and the industry.[53]

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[49] *M. S. Engelman*, 8 B.T.A. 1289 (1927); *Gertrude G. Rubenstein*, 10 B.T.A. 864 (1928); *Ushco Mfg. Co.* v. *Commissioner* (2 Cir. 1945), 151 F. 2d 821.

[50] *Matter of Dupignac*, 211 N.Y. App. Div. 862 (1924).

[51] A.R.M. 34, 2 Cum. Bull. 31 (1920); *Maltine Co.*, 5 T.C. 1265 (1945); *Kimball Laundry Co.* v. *United States*, 338 U.S. 1 (1949); Merten's, *The Law of Federal Income Taxation*, Vol. 10a chapter 75 (rev. ed. 1948); *Estate of Straus*, 8 T.C. Memo. 442 (1949); cf. *Cohen* v. *Kelm*, supra, note 41.

[52] Note, "An Inquiry into the Nature of Good Will," 53 *Columbia L. Rev.*, pages 660-731 (May 1953). The theory of excess value is rejected as unsound; the separate valuation of good will should not be made, but the value of the enterprise as an entirety should be appraised (p. 712).

[53] *Estate of Henry A. Maddock*, 16 T.C. 324 (1951); *Charles F. Hubbs & Co.*, T.C. Memo. (1949); *Ruth M. Cullen*, 14 T.C. 368 (1950); *International Heater Co.*, T.C. Memo. 1951; Reg. 105, Sec. 81.10.

After establishing normal earning capacity over a representative period, the same procedure is followed to capitalize such earnings as in the case of closely held stocks. The choice of a rate or multiplier is of basic importance; it must be one which allows for all of the financial risks inherent in the business enterprise.[54]

The Treasury Department has used a split-rate formula for capitalizing normal and excess earnings. In a nonhazardous business, the rates used of 8 per cent return on tangibles and 15 per cent on the remaining earnings have been deemed appropriate. However, rates of 10 per cent and 20 per cent have been used recently by the Bureau but were revised downward on review by the Tax Court.[55] Combinations of rates which have been used in the decided cases do not furnish a reliable guide. Rates of capitalization of earnings are flexible and will vary according to the market risks and hazards prevailing at the particular date for which a valuation is to be determined.[56] A valuation for good will cannot be made apart from the going business with which it is identified. In valuing good will emphasis has been placed quite properly on the earning capacity, but only to the extent that it would survive in case of a transfer to a new ownership and management As noted by the Tax Court in a recent decision:[57]

> "It is important to remember, then, that when the purchaser of a business pays a price for good will, he is not paying for the profits in the past in excess of a fair return on tangibles, but those profits of the future."

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[54] *William A. Boyd*, 5 T.C. Memo. 791 (1946), affirmed (6 Cir. 1948), 171 F. 2d 546; *Henry L. Watkins*, 9 T.C. Memo. (C.C.H.), 448 (1950); *M. M. Gordon*, 9 T.C. Memo. (C.C.H.), 203 (1950); *J. R. Clem*, T.C. Memo. (1951); *Spitzer* v. *Commissioner* (8 Cir. 1946), 153 F. 2d 967; *McKinney Mfg. Co.*, 10 T.C. 135 (1948).

[55] *Estate of A. Bluestein*, 15 T.C. 770 (1950), Cf. *Cohen* v. *Kelm*, supra, note 41; *Robert R. Gannon*, 21 T.C. 1073.

[56] *Ushco Mfg Co.*, supra, note 49; *Floyd W. Estes* v. *Commissioner* (6 Cir. 1948), 168 F. 2d 68; *Rainier Brewing Co.* v. *Commissioner* (9 Cir. 1948), 165 F. 2d 217, rehearing denied 166 F. 2d 324.

[57] *Estate of A. Bluestein*, note 55, supra.

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Estate and Gift Tax Aspects of Drafting Survivor-Purchase Agreements

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The business advantages to a small, closely-held organization, whether operated as a partnership or corporation, of survivor-purchase agreements are well known enough not to require detailed discussion. The decedent's estate is provided with a market for an asset which might otherwise be liquidated at a forced sale. The surviving partners or stockholders are protected against interruption of business operations as the result of death or withdrawal. Misunderstandings and possibly litigation can be avoided. The valuable business purposes of such agreements are clear, but unless they are carefully drawn and with a view to producing the correct tax results they may fail completely in their purpose. Thus the results, without the disadvantages, are the aim of careful draftsmen.

1. Points to Consider

	Section
Will the agreement fix values for tax purposes?	2, 4, 5, 7
Methods of determining purchase price	3
Treatment of good will	3, 4
Restricting transfer of interest during life	5
Protecting against double taxation in decedent's estate	6, 8
Problem of whether survivor should have an option or obligation to purchase	7
Question of handling of insurance to fund purchase obligation	8
Integration with Wills of parties	9
Enforceability of agreements	10
Gift tax aspects of such agreements	11

2. Valuation of Interest for Tax Purposes

These agreements may constitute a dangerous trap if they do not peg the value of the selling interest for purposes of determining death taxes. The agreement, if properly drawn, should be specifically enforceable at the price fixed, even though this might be substantially less than the value of the interest as determined by a Revenue Agent. For estate-tax purposes, the fair-market value of a business interest or of stock owned by a decedent is determined by reference to the net value of underlying assets as well as their demonstrated earning capacity.[1] Such factors will be taken into consideration for tax purposes. If the price paid is not commensurate with them, the Commissioner will consider himself free to determine his own figures, whether to the detriment of the decedent's estate or not. It is important, therefore, that a method of determining the price be used which is flexible enough to be realistic at some future date.

3. Valuation of Interest, Including Intangibles

It is quite important, first, that the parties recognize the existence of intangible values in the business, if such be present, and, second, that proper methods of determining the price allocable to such items be fully and adequately provided in the agreement. Various methods of determining a future sale price may be used. The most common is to use book value, at least as a starting point. This method is most frequently applicable in partnerships where the book value of a partner's interest is readily determinable. Other common methods are agreed values, the use of appraisals, fixing formulas for the capitalization of past earnings to value good will or other intangibles, or by reference to the value that may be determined for inheritance or estate-tax purposes. Each method has advantages and disadvantages, and careful consideration of these factors in deciding which method is most appropriate to the business in question is suggested.[2]

The most important general suggestion in this connection is that, whichever approach may be adopted, care be used in drafting the agreement so that its application to the facts at some indeterminate, future date not be left uncertain. For example, in the case of book values consideration must be given to the question of whether the actual value of any items which may have appreciated over their book figures will be taken into account. The treatment of valuation reserves should be covered, and a thorough analysis of the business accounting system should be made before drafting the agreement. Items not ordinarily shown on the books, or entered at only nominal figures, must be taken into account. Good-will, unrealized profits, and contingent liabilities are examples of this type of problem.

Care should also be taken to determine the date as of which book value will be taken. This is particularly true in the case of partnerships where the date of death seldom coincides with the end of a regular partnership accounting period. If possible, a method should be adopted which would not necessitate a special closing of the books, taking of an additional physical inventory, and so forth.

It is sometimes provided that the selling price will be determined by the value of the interest as fixed for estate or inheritance-tax purposes. This procedure has the advantage of tying the two determinations together, but a substantial period of delay may result before these taxes are finally determined. Treatment of earnings in the interim should not be left open if this method is adopted.

Another point to keep in mind in using this approach is to provide, insofar as possible in the agreement, that representatives of the purchasing interest shall have an opportunity to offer evidence or otherwise participate in the valuation hearings. Otherwise they might be considered strangers to a proceeding in which representatives of the selling estate might not be prompted to a proper concern for the value fixed by the taxing authorities. The purchaser might find himself contributing unduly for the benefit of not only the seller but the tax gatherer.

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[1] Reg. 105, § 81.10(a), (d).

[2] For a discussion of the use of various valuation methods see Richard Forster, "Valuing a Business Interest for the Purposes of a Purchase and Sale Agreement," *Stanford Law Review*, April 1952, Vol. 4, page 325.

The key concern of the draftsman is to make it clear what standards will apply in the application of whatever method of valuation is adopted.

4. Good-will

The principal intangible in valuation questions is generally centered in good-will. Frequently the parties do not recognize, between themselves, that such a factor exists, or, if they do, they do not care to include it in measuring the price to be paid. The Tax Court takes the position that if the Commissioner can show, by application of the usual criteria, that good will of the business did exist, a survivor-purchase agreement will not serve to eliminate a tax attributable to this item even though no payment is to be made therefor.[3] On the other hand, the Second Circuit has recently adhered to the rule of the *Lomb* and *Wilson* decisions[4] in affirming a decision of the United States District Court, for the Western District of New York, which held an agreement between father and son controlling for tax purposes, even though its effect was to transfer valuable stock at a zero figure.[5]

The Tenth Circuit Court of Appeals has also adopted a position equally favorable to the taxpayer. In *Brodrick* v. *Gore*, 224 Fed. 2d 892, the Court held that a partnership agreement between a father and two sons, which provided that the surviving partners could purchase the interest of a deceased partner at the book value, controlled the estate tax valuation of the interest even though the actual value was approximately $200,000 greater than the book value. This result was reached even though the proceeds passing to the father's estate reverted to the sons under the father's will. The Court said that the family relationship alone was not ground for disregarding an otherwise bona-fide agreement. The position of the Revenue Service is set forth in Revenue Ruling 157 and Revenue Rulings 54-56 and 54-77.[6]

An agreed capitalization of past earnings is perhaps the most equitable method of fixing the price to be paid for good will between the parties. Care should be used in describing the earnings period to be used so the "normal" record of the business will be fairly reflected as nearly as possible. Another approach would be to agree on a fixed amount to be paid for this item. If a fixed amount is to be used, it should not only be realistic in the light of facts known when the agreement is drawn but it is well to review the figure periodically to be sure later evidence effects no substantial change in the picture. Since the good intentions of the parties in this regard sometimes go astray, a savings clause might be added in this type of case to the effect that the price set in the agreement shall not be applicable if more than a certain amount of time has elapsed since it was last reviewed prior to the agreement becoming operative. In such event the alternative method to be used should, of course, be specified.

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[3] *Estate of Maddock*, 16 T.C. 324 (1951); *Estate of Trammell*, 18 T.C. 662 (1952); see also, *Minoff* v. *Margetts*, 81 Atl. 2d 369 (N.J.).

[4] *Lomb* v. *Sudgen* (2 Cir. 1936), 82 F. 2d 166; *Wilson* v. *Bowers* (2 Cir. 1932), 57 F. 2d 682.

[5] *May* v. *McGowan* (2 Cir. 1952), 194 F. 2d 396; affg. 97 F. Supp. 326.

[6] 1953-2 C.B. 255, 1954-1 C.B. 187 and 194.

5. Restrictions on Inter-Vivos Transfers

One of the basic considerations in determining whether such agreements will control, or influence, estate-tax values is whether they restrict inter-vivos transfers as well as transfers at death. Agreements which become operative only upon death, leaving both parties free to dispose of the interest at will during their life, have been considered to be primarily testamentary in nature, with full ownership of the stock or business interest not terminating until death.[7] The fact alone that an agreement may be considered testamentary in nature should not, of itself, influence or determine the value of the interest, but such agreements appear suspect, even though no relationship exists between the parties as in the *Matthews* case, but particularly where one party is the natural object of the other's bounty.[8]

If the agreement becomes operative only at death and the price is not adequate in the opinion of the Revenue Agent, an argument will be made that it constitutes a transfer of the excess values claimed to exist which would be taxable under Section 2036 or 2037 of the Code as a transfer effective at or after death. It should not be inferred that an inter-vivos restriction alone will determine the question, but it is a factor which may weigh heavily.

This was one of the factors considered significant by the District Court in the *May* case.[9]

Should the parties be unwilling so to restrict themselves, a compromise might be indicated where each would give the other a first option to purchase at a price determined by any bona-fide offer received. A definition of what will be deemed such a bona-fide offer should be attempted in the agreement.

6. What Asset Will be Taxed to the Decedent's Estate?

This problem may arise in cases where a survivor-purchase agreement is funded by insurance. Care must be used to assure that both the policy proceeds and the business interest itself are not included in the decedent's estate. Properly drafted, the agreement will provide that all insurance will be maintained either by the purchasing corporation, prospective purchasing partner, or by an independent Trustee. The holder of the policy receives the death proceeds, which are then applied in discharge of the purchase obligation.

In the *Tompkins* case[10] the purchase agreement provided that the insured partner had the right to change the policy beneficiary. All premiums on both policies had been paid by the partnership and charged to partnership expense. The Court held that only the insurance proceeds were taxable in the estate under these circumstances, citing its earlier decision in *Dobrzensky*[11] where it was considered that the policy proceeds were, in effect, acquired by purchase, the consideration being the partnership interest relinquished.

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[7] *Estate of Matthews,* 3 T.C. 525 (1944); *Claire G. Hoffman,* 2 T.C. 1160, 1176 (1943).

[8] *Claire G. Hoffman,* supra.

[9] *May* v. *McGowan* (D.C., W.D. N.Y. 1950), 97 F. Supp. 326.

[10] *Estate of Ray Tompkins,* 13 T.C. 1054 (1949); see also, *Estate of G. C. Ealy,* par. 51137, Prentice-Hall Memorandum T.C. (1951).

The Court pointed out in the *Dobrzensky* case that if the proceeds of the insurance were less than the value of the partnership interest, the excess would be includible in decedent's estate, probably under 2033 of the Code. However, *Tompkins* held that the effect of the purchase agreement was to limit the decedent's interest in the partnership assets to the amount of insurance received. It had been stipulated that the actual value exceeded the proceeds by about $3,000. It is questionable that this result would follow if the discrepancy were substantial. The Revenue Service would probably argue that the *Dobrzensky* rule had not been modified by *Tompkins* or possibly that the result was a 2036 transfer for an insufficient consideration.[12] Acquiescence in the *Tompkins*' decision[13] largely eliminates the problem of double taxation although if the agreement is not properly set up, it could be troublesome since the two items are taxable under different sections of the Code.

It is important that the source of premium payments not become obscure, particularly in the case of partnership interests. If the premiums are paid with partnership funds, they should be properly charged on the books to the account of the partner who owns the policy and not simply to an insurance account.

Although both the business interest and the insurance proceeds will not be taxed if the agreement is prepared properly, it is clear that both cannot be excluded.[14] The proper result would appear to be that the partnership interest, or the stock, would be taxed to the extent of its value, either as determined by the agreement or otherwise. Logically, the insurance proceeds received by the purchaser should not be taxed.

Of course, the cash surrender value of any policy held by decedent on the survivor's life will be includible in the estate. The agreement should provide that this policy may be acquired by the named insured upon payment to the estate of the value thereof to avoid income-tax transferee-for-value problems which might arise if anyone else should acquire the policy.[15]

If the value of the business interest should, by chance, be less than the insurance proceeds, usually payable in full under survivor-purchase agreements, an attempt would probably be made to tax the estate on the excess value of the policy under the theory that in such case the partnership interest had in effect been used to acquire the insurance proceeds,[16] even though 2042 were inapplicable. As a practical matter, it is quite unlikely that the interest would be valued, for tax purposes, at less than its selling price pursuant to the agreement.

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[11] M. W. *Dobrzensky*, 34 B.T.A. 305 (1936).

[12] IRC § 2043(a).

[13] Acq. 1950-1 C.B. 5.

[14] Cf. *Estate of Reicker*, par. 44397, Prentice-Hall Memorandum T.C. (1944).

[15] Cf. 1954 IRC § 101 limiting the transferee for value rule to transfers not made for a business purpose. A transfer to the insured will be exempt from the rule.

[16] M. W. *Dobrzensky*, supra.

7. Options to Purchase versus Obligations

If the agreement merely extends an option to the survivor to purchase the decedent's interest, additional uncertainty is introduced in that a post-death decision of the survivor will become operative, retroactively, on the valuation problem. If the option is exercised, the purchase and sale becomes an obligation which normally should bind the Government. If not, the agreement presumably has no bearing on the problem. From a tax point of view, a firm obligation seems preferable, and from the standpoint of the parties' personal interests the same result would appear to follow. Only thus is each given assurance that his estate will be protected against a forced sale.

A keynote in drafting agreements of this type should be that the parties approach all negotiations on an arm's-length basis, realizing fully that neither can determine which will survive and, therefore, that neither should consider the problem from the standpoint that he wishes the right to decide whether he will or will not purchase the interest upon the death or withdrawal of his associate or partner. When agreements are negotiated with this in mind, a fair and equitable result will generally follow.

8. Use of Insurance to Fund Purchase Obligation

Since one of the basic purposes of survivor-purchase agreements is to provide a ready market to the decedent's estate, indemnification of the obligation by insurance serves to minimize the possibility that restrictions of state law, business obligations, and other unforeseeable factors may make it difficult or impossible for the survivor to comply with his agreement. Basically, no agreement is any better than the ability of the party to perform, or to be held for non-performance. The cross-purchase program, wherein each stockholder or partner obtains a policy on the life of the other, retains all of the incidents of ownership and pays the premiums, is clearly the most desirable in the case of a closely-held business.[17] In the case of larger organizations involving three or more owners, the complications arising from numerous cross-policies justify consideration of a program whereby the corporation or the partnership, as such, or a trust, will acquire the policies, premium payments being properly charged to the drawing accounts of the respective owners in the case of the partnership.

One consideration which must not be overlooked, in the case of a corporation, is whether the insurance proceeds will or will not be taken into account in determining the value of the stock. The most equitable result would appear to be to give the decedent's estate the benefit of the decedent's share in the increase in stock value attributable to the insurance proceeds by providing for the use of book value following the date of death. In the case of a corporation, only the cash value of the policies will be shown in its balance sheet, the premiums paid in excess of this amount being charged to surplus. The book value of the stock immediately following the death of an insured stockholder is increased by his pro-rata share of the insurance proceeds in excess of the cash value of the policy. The agreement, on the other hand, might provide that the book value would be as of a date immediately preceding death, in which case none of the insurance proceeds would be reflected. This is another problem which should not be overlooked in the preparation of the agreement.

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[17] See *Paul Legallet*, 41 B.T.A. 294 (1940).

9. Integration of the Purchase Agreement with the Wills of the Parties

Since the business interest may constitute a substantial portion of the assets of a decedent, its effect should be taken into consideration in the preparation of his Will. If the proceeds are to be paid directly to a widow or other beneficiary, creditors of the decedent would have a right to complain if, as a result, a substantial portion of the assets available to pay their claims did not pass through the probate estate. One California decision indicates that if creditors were not otherwise protected, they would have a right to reach the proceeds payable pursuant to such a survivor-purchase agreement.[18]

It is also advisable for the Will to direct the Executor to comply with the agreement, to authorize him to do anything necessary to carry its terms into effect, and perhaps to permit him to carry on decedent's business insofar as this may be necessary during the interim of the operation of the purchase and sale agreement.

10. Right to Specific Performance

Although it seems reasonable to assume that the interest being purchased and sold is of a unique character, it might not be entirely clear that the agreement would support an action for specific performance. To allay this problem it is suggested that recitals be contained to the general effect that the subject matter is of an unusual and unique nature and that each of the parties recognizes that the other will have a right to bring an action for specific performance in the event of a failure to perform or to enjoin a threatened breach.

11. Gift-Tax Problems

The principal gift-tax problems of survivor-purchase agreements are two. First, whether the execution of the agreement itself can constitute a taxable gift. Obviously it is not possible, as of the effective date, to determine which party would be the donor and which the donee since that must depend on which is the survivor. Nevertheless, if one is the natural object of the other's bounty and the fixed price to be paid does not appear to be fair and reasonable, it might be argued that the mere execution of the agreement would constitute a taxable gift with a life interest retained. If so, it is clearly a gift of a future interest as to which no annual exclusion would be available. It would also be a type of gift which would be includible in the donor's gross estate under the Internal Revenue Code.[19]

If the purchase price is adequate, clearly no gift is involved.[20] This problem would also not arise in a first refusal type of agreement since there could be no present transfer of any sort and presumably the consideration will be adequate.

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[18] *Wood* v. *Gunther*, 89 Cal. App. 2d 718; 201 Pac. 2d 874 (1949).

[19] 1954 IRC § 2037; 1939 IRC § 811(c).

[20] Reg. 108, § 86.8.

Second, what effect do such agreements have upon the valuation of stock or of an interest presently transferred? This, of course, assumes that inter-vivos transfers are not restricted by the terms of the agreement, which, as previously indicated, should be used only to a limited extent. The difference in approach from estate-tax valuation is that the right to retain the property during life is a factor of value which must be considered. The leading case on the subject is *McCann*,[21] holding that the value of certain stock, transferred from a husband to his wife, was not limited for gift-tax purposes to its book value although that was the figure at which the corporation was obligated to acquire the stock upon termination of any stockholder's employment and at which the owner was obligated to sell. It was held that the right to receive dividends and other attributes of ownership must be taken into consideration in determining value for gift-tax purposes. It is clear, however, that such restrictions would be evidentiary on the value question since any asset not freely marketable is of less value than one without such restrictions.[22]

Proper drafting of survivor-purchase agreements is a joint enterprise wherein the client is best served if his attorney, his accountant, and insurance counsel, if insurance is involved, all cooperate to the end that the agreement will ultimately be workable in the light of the many problems in which each specializes.

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[21] *Commissioner* v. *McCann* (2 Cir. 1944), 146 F. 2d 385; see also, *Spitzer* v. *Commissioner* (2 Cir. 1946), 153 F. 2d 967; *Kline* v. *Commissioner* (3 Cir. 1942), 130 F. 2d 742.

[22] *Worcester County Trust Co.* v. *Commissioner* (1 Cir. 1943), 134 F. 2d 578.

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How to Make Restrictive Deals Fixing Value of Property

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The problems which surround the determination of the fair market value[1] of a given item of property in terms of dollars as of a particular date are among the most crucial and difficult which confront the tax practitioner today. Because of the statutory burden of proving the correctness of an evaluation made on the basis of competent evidence, the taxpayer is often met with a barrier which, as a practical matter, may prove to be insurmountable. It is therefore axiomatic that any restrictive deal fixing the value of property, which a taxpayer is able to enter into in advance, may well prove invaluable in rebutting a subsequent contrary contention by the Treasury. It is the purpose of this chapter to examine the tax consequences of these restrictive agreements and thereby to show how they can best be made.

1. Points to Consider

Assume your client wishes to enter into a restrictive agreement. Your first problem will concern itself with the following questions:

	Section
What is a restrictive agreement and what is its scope?	3 and 4
What can be accomplished by a restrictive agreement?	6
What is its tax effect?	5 and 8

To find the answers to the last question, many points must be considered:

	Section
The necessary correlation of income tax valuation problems with those of estate and gift taxes	2
Problems of stockholders and corporations:	
Close corporations	9
Form of Restrictive Shareholders' Agreements	10
Stock redemption	11
Surtax on Improper accumulation of surplus	12
Restricted stock for corporate executives	13

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[1] Reg. 105, § 81.10 "*Valuation of property.* (a) . . . the fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell."

Section
Unilateral options 14
Options that take effect on death 15
Problems of partners and partnerships .... 16 and 17

When you have determined that a restrictive agreement will be entered into, the following problems should be covered:

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Drafting 7
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2. Necessary Correlation of Income Tax Valuation Problems with Those of Estate and Gift Taxes

Income taxes are generally concerned with cash transactions, while in the estate and gift tax field, only a comparatively small portion of the taxable transfers involve cash. Consequently, it is self-evident that most valuation problems involve estate and gift, rather than income, taxes. However, the rules governing the valuation of property are the same for all three types of tax, and it is therefore considered impractical to confine this chapter entirely to income taxes as such. Furthermore, the provisions of the Internal Revenue Code for determining the income tax basis of property acquired by gift[2] or inheritance[3] are dependent on the fair market value of the property on the date of acquisition, which will almost invariably be the estate or gift tax value placed on the prior transfer.

3. Definition of Restrictive Agreement

For our purpose, a restrictive agreement might be defined as a binding contract, presently entered into, that will at some future date control the price to be paid for a business interest, and usually the identity of the purchaser.

4. Scope

The "business interest" with which we will here be concerned is invariably represented by stock in a closely held corporation or a partnership interest.

5. Law and Regulations

Nowhere in the Internal Revenue Code or the Regulations issued thereunder is the effect of a restrictive agreement discussed as such.[4] Consequently, it has been left to the judiciary to develop this field of our tax law.

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[2] 1954 IRC § 1015(a) and 1939 IRC § 113(a)(2) provide that the basis of property in the hands of a donee, for the purpose of computing loss on such property, is the fair market value of such property at the date of gift, if such value is lower than the donor's basis.

[3] 1954 IRC § 1014(a) and 1939 IRC § 113(a)(5) provide that the basis of property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent is the fair market value of such property at the time of death.

[4] The Treasury has published a series of rulings dealing with effect of restrictions on the sale or transfer of stock on market value. The first of these (Rev. Rul. 157, I.R.B. 1953-17, 16)

6. What Can be Accomplished by a Restrictive Agreement?

Men embarking on a business venture are generally anxious to provide themselves with assurance that they will never be subjected to a business association with strangers. For example, they may be unwilling, upon the death of one of their number, to continue to work indirectly for the benefit of the deceased's widow, or perhaps even directly for her new husband. On the other hand, they are well aware of the fact that death will often compel the sacrifice of a valuable business in order to meet the pressing demands of debts, probate expenses, and estate and inheritance taxes. Thus it is always well to keep in mind that while this chapter deals primarily with the tax aspects of these restrictive agreements, they usually have their genesis in non-tax considerations such as these:

a. Provision for precise and equitable disposition of a stockholder's or partner's interest on his death or retirement.

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held that where the by-laws of a corporation contain a binding agreement, effective *only* on a shareholder's death, providing for the sale to the corporation of the shareholder's interest in the business at a price not reflecting any consideration for good-will, the Treasury would not be precluded, for estate tax purposes, from evaluating the shareholder's interest in the business so as to include good-will. Then, in Revenue Ruling 189, I.R.B. 1953-19, 19, the Treasury ruled as follows with respect to the effect of stock restrictions on valuation for gift tax purposes:

"Restrictions attaching to shares of corporate stock, providing that the owner may not sell, transfer, or otherwise dispose of the shares without first offering them for sale to certain interested persons at a fixed price, or at a price determined by the application of a particular formula, while a factor to be considered with all other pertinent factors of valuation, are not binding upon the Commissioner in determining fair market values for Federal gift tax purposes. See *Estate of Halsted James* v. *Commissioner*, 148 F. 2d 236; *Charles T. Kline* v. *Commissioner*, 130 F. 2d 742; *Frederick Kraus, et al.* v. *United States*, 140 F. 2d 510; *Commissioner* v. *Harrison K. McCann*, 146 F. 2d 385; *Harry H. Spitzer* v. *Commissioner*, 153 F. 2d 967. Also see Rev. Rul. 157, I.R.B. 1953-17, 16."

The next in this series (Rev. Rul. 54-76, I.R.B. 1954-9, 23) held that where a shareholder acquires stock from a corporation subject to an option reserved by the corporation in the articles of incorporation to repurchase the stock at a specified price before *any* sale or transfer, including a transfer on death of the shareholder, the option price will usually control the estate tax value of the stock, particularly if the option is in fact exercised. Finally, in a lengthy ruling outlining the various factors to be considered when valuing the stock of closely held corporations (Rev. Rul. 54-77, I.R.B. 1954-9, 17), the Treasury had the following to say with respect to restrictive agreements:

"Sec. 8. Restrictive Agreements. Frequently, in the valuation of closely held stock for estate and gift tax purposes, it will be found that the stock is subject to an agreement restricting its sale or transfer. Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes. See *Rev. Rul.* 54-76 below. However, in such cases the option price is not determinative of fair market value for gift tax purposes. Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well as at the death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bona fide business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. In this connection see *Rev. Rul.* 157, I.R.B. 1953-17, 16 and *Rev. Rul.* 189, I.R.B. 1953-19, 19."

b. Provision for incentive compensation of corporate employees, by giving them an equity interest in the corporation while, at the same time, limiting their right to dispose of that stock to outsiders.

c. Guarantee of retention of corporate management and control within initial group of stockholders.

d. Prevention of untimely liquidation of the corporation or partnership.

e. Provision for a market for a deceased or retiring stockholder's stock or partner's interest, which might otherwise be unmarketable.

7. Drafting

These restrictions may be injected into partnership agreements, stockholders' agreements, pre-incorporation agreements, the by-laws, the corporate charter, or a variety of other legal documents. Indeed, the corporate statutes of many states require that in order that the agreement be effective against third party transferees, its terms clearly appear on the face of the stock certificate itself.

It is only natural that the form and terms of these agreements vary widely, depending primarily on what they are intended to accomplish. However, since the Treasury is almost certain to subject any such agreement to extremely close scrutiny, the obvious time for consideration of these problems is before the agreement is drawn. It hardly seems necessary to mention that this calls for a lengthy and careful weighing of all the various factors involved, to be followed up by meticulous and precise draftsmanship.

8. Tax Effect

Perhaps Randolph Paul best described the current state of our tax law on this subject when he wrote: "While restrictive agreements may be taken into consideration in fixing market value, and sometimes may control by themselves, other factors of valuation are generally relevant." [5]

Basically, the effect of any restrictive agreement upon the fair market value of the interest dealt with therein is dependent upon the terms and provisions which have been inserted in the agreement. Determinative in this regard will be the possible existence of such practical considerations as:[6]

a. The relationship of the parties.

b. The terms of the agreement.

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[5] Randolph E. Paul, *Supplement to Federal Estate and Gift Taxation*, Sec. 1834. Boston: Little, Brown and Company, 1946.

[6] *Commissioner* v. *McCann* (2 Cir. 1944), 146 F. 2d 385, 33 AFTR 384. Certain corporate employees held a Class B common stock subject to a by-law provision that they sell (and the corporation buy) the shares to the corporation at book value upon the termination of their employment. The employees could, with the consent of the Board of Directors, transfer the stock to other employees but no other transfer was allowable. The taxpayer stockholder had obtained the consent of the Board of Directors to give the stock to his wife, a fellow employee, and now asserted that the book value, a figure substantially less than the then market value, was controlling for gift tax purposes. The Circuit Court held that it was not, and that the Tax Court had erroneously refused to consider such relevant factors as the right to retain the stock and receive dividends, the prospective earnings, the likelihood that the donor would not retire, his life expectancy, his opportunity to sell to another employee, his power to change the by-laws.

c. The circumstances under which the restriction is to become operative.
d. The probability of the restriction becoming operative.
e. The value of the right of the stockholder or partner to retain his interest.
f. The stockholder's right to sell free of restriction during his lifetime.

9. Close Corporations

The power of a stockholder to sell his stock to whomever he wishes and at the best price obtainable is one of the natural incidents of stock ownership. The fact that this power is circumscribed by restrictions obligating the stockholder to sell or offer his stock only to certain persons at a certain price will be reflected in the market value of that stock.[7]

10. Form of Restrictive Shareholders' Agreements

Restrictive shareholders' agreements often take the form of an "option" giving the continuing stockholders,[8] the corporation, or both, the right to purchase the stock of a deceased or retiring stockholder at a particular price. On the other hand, the agreement may provide for an "obligation" to purchase. Basically, however, these shareholders' agreements fall into the following general categories:

a. Cross options. Here the estate of the deceased shareholder or the retiring shareholder is merely obligated to offer the stock at a certain price to the continuing shareholder or to the corporation. These agreements are mutual in nature.

The principal weakness inherent in such an option arrangement results from the fact that there is usually little market for the stock of a close corporation. An unexercised option is small solace to a shareholder desiring to retire from active participation in the business, or to the legatee of a deceased stockholder, both of whom may be left at the mercy of a group of continuing or surviving stockholders, in whose business judgment they have little or no faith. One way of avoiding this unfortunate contingency is to include in the agreement provisions for the liquidation of the corporation in the event that the option remains unexercised.

b. Absolute obligation imposed on the continuing stockholders to purchase. Here the dangers are twofold: (1) The obligation virtually compels continuation of the business at a time when the death or retirement of an important stockholder may make such a course impractical; and (2) Death or retirement at a time when the financial resources of the continuing stockholders are low might force them to raise the purchase price through the declaration of corporate dividends, fully subject to normal and surtax.

The necessity for a dividend can, of course, be avoided by funding the agreement with life insurance. The ramifications of such a plan are discussed later in this chapter.

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[7] In *Helvering* v. *Salvage*, 297 U.S. 106, 16 AFTR 1322 (1936), the taxpayer, an individual, in consideration for his agreement not to compete with a corporation, was permitted to buy from the corporation, at a par value of $100 per share, stock with a then fair market value of $1165 per share. The corporation retained an option to repurchase a portion of the stock at par. Upon the subsequent disposition of that portion of the stock the taxpayer claimed a cost basis of $1165 a share. The Supreme Court sustained the Commissioner's contention that the option limited the taxpayer's basis in the shares in question to $100 a share.

[8] In most cases, it would seem advisable to make the corporation a party to the agreement, even though it runs between the stockholders individually and entitles the corporation to no option rights.

c. Corporate obligation to purchase. A withdrawal of dividends is not necessary if the corporation is given the first option to purchase. However, in certain jurisdictions, an agreement by a corporation to purchase its own stock is unenforceable for lack of consideration. These holdings are based on the fact that a corporation can only purchase its own stock out of surplus, which may or may not exist when the time for performance of the contract arrives. It would seem that this objection can be overcome by the use of language in the agreement which clearly imposes the corporate obligation to purchase only if a surplus exists.[9] As a practical matter, the fact that the stockholders will be compelled to purchase the stock if the corporation cannot will invariably cause them to arrange for the corporate purchase, even though the agreement might be unenforceable in the particular jurisdiction.

11. Stock Redemption

As is pointed out in the preceding paragraphs, the continuing shareholders will usually have to finance any outright purchase of stock from the retiring shareholders with funds which already have been through the individual tax wringer. Hence, from their point of view, a corporate redemption is generally preferable, permitting them, in effect, to finance the acquisition with corporate funds.

A word of warning here: The form in which this type of transaction is cast is always important. Under no circumstances should a corporation, with current or accumulated earnings, be placed in the position of discharging the purchase money obligation of the acquiring shareholders. For example, take the case of the corporation with two shareholders—A and B—that redeems B's stock after A has personally obligated himself to make the purchase. In this situation, the Courts have held that, for tax purposes, the transaction is divisible into two parts: A is deemed to have received the purchase price from the corporation as a fully taxable dividend, and thereupon, to have utilized the funds so obtained personally to purchase B's stock.[10]

What, then, are the tax results of stock redemption to the surrendering shareholders? Just as with all other such distributions, they will realize capital gain or loss on the exchange,[11] unless the redemption is "essentially equivalent" to a taxable dividend; in which event, the law provides that it will be taxed as such to the extent of corporate earnings.[12]

Whether a stock redemption is essentially equivalent to a taxable dividend will always depend upon the circumstances of the particular redemption. In order to be so construed, the distribution must ordinarily be close to pro rata stockholders.[13] In other words, there must be a close proportionate relationship in the identity of the surrendering and the continuing stockholders. Thus, a redemption of all the stock of a particular shareholder, so that he ceases to be interested in the affairs of the corporation, is not essentially equivalent to a taxable dividend.[14] Since the run-of-the-mill redemptions with which we are here concerned usually involve all the stock of a retiring or deceased shareholder, they are obviously not within the scope of this section.

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[9] Some legal authorities have suggested the imposition of a two-fold corporate obligation in order to support the promise of the stockholder to sell: (1) to have a surplus, and (2) to purchase.

[10] *Wall* v. *U.S.* (4 Cir. 1947), 164 F. 2d 462, 36 AFTR 423. See also, *Boyle* v. *Commissioner* (3 Cir. 1951), 187 F. 2d 561, 40 AFTR 312; *George D. Mann*, 33 B.T.A. 281 (1935).

[11] 1954 IRC §§ 331(a)(2) and 302(a); 1939 IRC § 115(c).

[12] 1954 IRC § 302; 1939 IRC § 115(g).

[13] 1954 IRC § 302(b)(2) specifically excludes from taxability as a dividend any redemption lowering a shareholder's stock ownership to less than 80% of what it was before redemption.

However, in the case of a partial retirement, its application will generally hinge on whether the redemption substantially alters the equities of the various stockholders. Here the law previously worked a particular hardship in closely held family corporations where the funds needed to pay estate and inheritance taxes of a deceased sole or majority stockholder could often be raised only through partial redemption. This provision, together with the fact that many substantial estates lacked sufficient liquid assets to pay these death taxes, undoubtedly forced the sale or liquidation of many close corporations. It was to remedy this unhealthy trend that the Revenue Acts of 1950, 1951 and 1954 amended the law so as to provide, in substance, that if the value of stock of a corporation comprises more than 35 per cent of the value of the decedent's gross estate, or 50 per cent of the net taxable estate, a redemption of part of such stock, to the extent that the amount paid therefor is not in excess of death taxes, funeral and administrative expenses shall not be regarded as equivalent to a dividend.[15]

12. Surtax on Improper Accumulation of Surplus

The law imposes a stiff penalty surtax on a corporation which is formed or availed of for the purpose of preventing the imposition of surtax on shareholders through the accumulation of earnings beyond the needs of the business.[16] Any accumulation for the purpose of creating a surplus to purchase the stock of a deceased or retiring stockholder should be considered in the light of this section.[17] In other words, will its presence be regarded as evidence that the corporation did not need all of its surplus for use in the business?

While there are as yet no decided cases on this specific point, it is likely that the accumulation would be sustained as a reasonable use of surplus funds. In several analogous cases, the Courts have upheld the purchase of "key-man life insurance" by a corporation to indemnify it against the loss which it will incur on the death of a key officer as a sound business use of corporate funds.[18]

13. Restricted Stock for Corporate Executives

High individual income tax rates make Uncle Sam the only real beneficiary of current increases in the fully taxable ordinary income of those executives already in high tax brackets. The corporate executive may sometimes avoid this harsh result by arranging to take his increased income in the form of either (1) deferred compensation in future years when he may be in lower tax brackets, or (2) capital gains.

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[14] 1954 IRC § 302(b)(3); Reg. 118, § 39.115(g)-1(a).

[15] 1954 IRC § 303; 1939 IRC § 115(g)(3).

[16] 1954 IRC §§ 531 through 537; 1939 IRC § 102.

[17] Within the possible scope of the penalty surtax would be contributions to a sinking fund, and the increment in cash values of life insurance policies, for the purpose of funding a stock retirement agreement.

[18] *General Smelting Co.*, 4 T.C. 313 (1944), and *Emeloid Co., Inc.* v. *Commissioner* (3 Cir. 1951), 189 F. 2d 240, 40 AFTR 674.

Under our present tax structure, long-term capital gains are taxable at the attractive maximum effective rate of 25 per cent.[19] However, in order to realize capital gains, you must first become the owner of a capital asset which you can at some appropriate time sell at a profit. Prior to the Revenue Act of 1950, the use of the so-called stock option as a means of accomplishing this objective was severely limited by the Treasury's view that, where an employee was given a right to buy his corporate employer's stock at a bargain price, if the fair market value exceeded his cost when the option was exercised, that excess was fully taxable ordinary income to him.[20]

The Revenue Act of 1950 provided more favorable tax treatment for the so-called "restricted stock option" granted to an employee to purchase stock in his corporate employer, if at the time of issuance the option price is at least 85 per cent of the market value of the stock. If various other statutory provisions are complied with, the employee gets a double tax break, in that (1) he will realize no taxable income until he sells his stock, and (2) at least a substantial portion of that income will be long-term capital gain.[21] Although any further discussion of this statutory type of "restricted stock option" is beyond the scope of this chapter,[22] it is important that your attention be directed to an apparently simple method of accomplishing the same desirable objective without meeting the stiff requirements of the statute.

The idea here is simply to place restrictions on the subsequent transfer of the stock to be sold to the executive, which will have the effect of temporarily reducing its fair market value to a nominal amount. The executive is then allowed to purchase this stock at the price to which its fair market value has been reduced. Obviously, there should be no prior commitment on the part of the corporate employer to permit the restrictions to lapse at any future date.

The Tax Court has held that the mere lapsing of the restrictions does not produce taxable income to the employee, and that his profit on subsequent sale of the stock is capital gain.[23] Furthermore, although the Treasury will usually endeavor to tax as compensation the spread between the market value and the cost of stock purchased by an employee pursuant to an option not fulfilling the statutory definition of a "restricted stock option," the Tax Court has held that the purchase of stock subject to restrictions on subsequent sale does not result in taxable income to the purchasing employee, despite the fact that such stock would be worth considerably more without the restrictions.[24]

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[19] 1954 IRC § 1201(b); 1939 IRC § 117(c).

[20] Reg. 118, § 39.22(a)-1.

[21] 1954 IRC § 421; 1939 IRC § 130A.

[22] For a general discussion of these provisions and other employee stock option arrangements, see chapter entitled "Compensation and Incentives for Executives," in this book.

[23] *Robert Lehman*, 17 T.C. 652 (1952); Acq. (I.R.B. 1952-4-13760, p. 1). Note, however, that the Treasury's acquiescence specifically leaves open the question of whether the profit on subsequent sale of the stock is to be taxed as capital gain or ordinary income.

[24] *Harold H. Kuchman*, 18 T.C. 154 (1953), Acq.

14. The Optioner Who Has Received No Comparable Option in Return for His Promise to Sell

First, we must settle the case of the shareholder who has sold for a cash consideration on the open market a "call" on stock owned by him. This sort of option will, in the absence of exceptional circumstances, control the fair market value of the optioned stock, even though option price is considerably less than its true value.

An employer-shareholder lacking such a cash consideration may grant such options to his employees in return for the rendition or continuation of valuable services. The tax effect of such an option hinges upon the ability of the optioner (or his estate) to provide the existence of a sound business need for its issuance.[25] This brings us to the so-called "testamentary options," a topic which will be discussed in the ensuing paragraphs.

15. Options That Take Effect on Death

The question to be considered here is whether the option of a deceased shareholder to buy stock from his estate, at less than true value, will control the fair market value of such stock for Federal estate tax purposes. These options may be either bilateral or unilateral, and the optioner may or may not have retained the power to sell the stock during his lifetime, unencumbered by the option.

Where a decedent gives such an option (either during his lifetime or by will) to a close relative or natural object of his bounty, there is little likelihood of its being regarded as anything but a form of testamentary disposition.[26] Consequently, the option price will be ineffective to reduce the true value at which the optioned stock will be subjected to estate taxation.

Even a bilateral option to buy only the shares owned on the date of death (and under which the optioner retains, during his lifetime, the unrestricted power to sell the stock unencumbered by the option) has been regarded as testamentary in nature, and therefore as not controlling the fair market value of the optioned stock on the date of death.[27]

This type of arrangement obviously works a particular hardship on the beneficiaries of an estate that is compelled by the agreement to sell the stock to the optionees at a price substantially less than its true value, on which the Federal estate tax may be imposed.

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[25] *Commissioner v. Bensel* (3 Cir. 1938), 100 F. 2d 639, 22 AFTR 170.

[26] In *Armstrong Estate* (7 Cir. 1945), 146 F. 2d 457, 33 AFTR 401, the decedent had given a unilateral option to an employee to purchase stock of his company upon installments which were to stop on the death of decedent's wife. Furthermore, in the event that the decedent was predeceased by his wife, the employee was to receive the stock without any payment. The Seventh Circuit upheld the decision of the Tax Court that, in the absence of a showing of a genuine business need for the agreement, it was really a testamentary transfer and the option price could not control the estate tax value of the stock.

[27] *Estate of James H. Matthews*, 3 T.C. 525 (1944); and *Claire G. Hoffman*, 2 T.C. 1160 (1943).

16. Partnerships

A partnership is an infinitely less complex form of business association than a corporation.[28] Consequently, a restrictive agreement fixing the price to be paid by a group of continuing partners to a retiring partner, or to the estate of a deceased partner, does not present the large number of problems that are involved in a restrictive stock purchase agreement.

None-the-less, where this type of agreement is entered into by a partner, its effects on the fair market value of the interest dealt with therein is a matter of prime tax significance. With the exception of those considerations that are inherently peculiar to the corporate form of doing business, it will usually be governed by the same general considerations regarding its terms and practical effectiveness discussed in other portions of this chapter.[29]

17. Payments to a Deceased or Retired Partner

The Internal Revenue Code of 1954 prescribes specific rules governing the treatment of payments made to a retiring partner or to the estate, heir, or other successor in interest of a partner. By and large, these new rules are applicable only to partnership taxable years beginning after December 31, 1954, and any part of a partner's taxable year falling within such partnership taxable year. The 1939 Code applies to all prior years. As will be explained below, it was not always clear under the 1939 Code, to what extent these payments should be treated as a distribution of the retiring partner's share of the profits and to what extent they represented capital gain from the sale of his partnership interest.

a. Under the 1939 Code: An agreement which simply provided for the survivors to acquire the interest of a deceased or retiring partner in exchange for a lump sum payment clearly constituted the outright purchase of a capital asset by the survivors. Therefore, there was nothing surprising about the tax results which resulted from this type of agreement. The survivors were not entitled to a tax deduction for payments made thereunder, and such payments were, in turn, ordinarily regarded as giving rise to capital gain in the hands of the recipient, to the extent that they exceeded his cost basis in the partnership interest.

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[28] (a) A partnership is a business association by agreement, into which no partner can be accepted without the consent of all others. (b) The Internal Revenue Code treats a corporation as a taxable entity, whereas a partnership is not. (c) A partnership terminates with the death of a partner, whereas a corporation can exist in perpetuity. (d) A partnership interest is generally incapable of representation by transferable shares, whereas a stock interest in a corporation is.

[29] In *Estate of George M. Tramell*, 18 T.C. 662 (1952), Acq., a partnership agreement between a husband and wife entitled the surviving partner to buy up the decedent's interest at a reasonable value based upon the partnership books, but specified that nothing was to be paid for good-will. The Tax Court upheld the Commissioner's right to add good-will when valuing the husband's interest for estate tax purposes, observing that, while the provisions of the agreement with respect to good-will were binding upon the partners, they were not binding upon the Treasury.

In *Estate of Robert R. Gannon*, 21 T.C. 1073 (1954), Acq., the Tax Court again upheld the Commissioner's right to disregard the provisions of a partnership agreement for valuation of a deceased partner's interest. In this case, an agreement between three brothers provided that the survivor could buy the decedent's interest at a price agreed on at the beginning of each year. One of the brothers died in October and the other two brothers bought his interest for the agreed upon value of $41,000. This value had been agreed upon as of the preceding January 1, and did not include the decedent's $18,000 share of the profits for the period January 1 to date of death in October. Despite the fact that the decedent's estate was apparently bound by the agreement and therefore did not actually receive this additional $18,000, the Court held that said amount must be reflected in the estate tax valuation of the decedent's interest in the partnership.

On the other hand, if the agreement stated that the retiring partner or representative of the deceased partner was to share in the firm's profits for a stipulated period after death or retirement as the purchase price of, or in lieu of, the partnership interest of the deceased or retiring partner, the survivors ran the risk of saddling themselves with an unexpected tax burden which could force them into bankruptcy. Here again, the survivors were often regarded as increasing their own capital investment with these income payments, which would therefore be taxed to them, rather than the actual recipient.[30]

Unfortunately, the court decisions under the 1939 Code established no clear rule governing the tax status of this type of income payment.[31] If it was desired to have the estate of retiring partner bear the burden of the income taxes on such payments, it was necessary to meticulously avoid the use of any language in the agreement which might be construed as indicative of a purchase or sale. The more recent decisions also indicated that this result could best be assured where the agreement permitting the retiring partner or his heirs to share in partnership income for a stipulated period recited that it was made in consideration of the mutual undertaking of the partners to do so. Payments made pursuant to this type of so-called "mutual insurance plan" were held excludable (or deductible) by the survivors, and therefore, taxable solely to the recipient.[32]

b. Under the 1954 Code: Actually, the usual payments to a retiring partner or to the estate or heirs of a deceased partner represent a number of items. They may, in part, cover the deceased's capital interest in the partnership. Such payments may also include his pro rata interest in unrealized partnership receivables and fees, or any potential gain or loss in partnership inventory. Then again, part thereof may be attributable to the type of mutual insurance plan referred to in the preceding paragraph. The 1939 Code contained no provision dealing with the tax treatment of such payments, and the court decisions to date thereunder have been inconsistent in their approach to the problem.

Section 736 of the 1954 Code provides that if a retiring partner or the successor of a deceased partner receives a share of partnership income in return for relinquishment of his partnership interest, the distributions are to be allocated between (a) payments for an interest in partnership property, and (b) other payments.

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[30] The following cases construed the agreement as providing for a purchase of the decedent's partnership interest and held the survivors taxable on the income payments: *Estate of George R. Miller*, 46 B.T.A. 35 (1942). Affirmed on other grounds *sub nomine McClennen* v. *Commissioner* (1 Cir. 1942), 131 F. 2d 165, 30 AFTR 238; *Pope* v. *Commissioner* (1 Cir. 1930), 39 F. 2d 420, 8 AFTR 10523; *W. Frank Carter*, 36 B.T.A. 60 (1937); *Edwards* v. *Commissioner* (10 Cir. 1939), 102 F. 2d 757, 22 AFTR 949.

[31] For decisions holding the income taxable to the estate, see: *Bull* v. *U.S.*, 295 U.S. 247, 15 AFTR 1069 (1935); *Estate of Frederick C. Bellinger*, par. 46,640 Prentice-Hall Memorandum T.C. (1946); *Charles F. Coates*, 7 T.C. 125 (1946); and *Raymond S. Wilkens*, 7 T.C. 519 (1946).

[32] *Sidney J. Hess*, 12 T.C. 773 (1949); *Courtland N. Smith*, par. 50,286 Prentice-Hall Memorandum T.C. (1950); and *Charles R. Whitworth*, par. 52,353 Prentice-Hall Memorandum T.C. (1952), affirmed 7 Cir. 6/12/53.

The amounts paid for an interest in partnership property represent a purchase by the survivors, who, of course, are allowed no deduction for such payments, with respect to which capital gain benefits are available to the recipients. However, the statute specifically excludes payments attributable to an interest in unrealized partnership receivables or good will (except to the extent that the partnership agreement provides for a payment with respect to good will) from classification in this category. Also, if any payments are attributable to the retiring partner's interest in certain substantially appreciated inventory, to this extent they will be regarded as proceeds from the sale of a non-capital asset.[33]

On the other hand, all other payments by the survivors (whether or not based upon partnership income) which are not made in exchange for the interest in partnership property of the deceased or withdrawing partners, are to be excluded from income of the survivors and taxed as ordinary income in the hands of the recipient.

18. Funding the Agreement

Because of the need for placing these restrictive agreements on a sound business basis, by putting in the hands of the prospective purchaser the ready cash with which to buy the deceased or retiring party's interest, an increasing number of business men have taken to funding these agreements with life insurance.

There are three basis principles affecting the tax consequences of such an insured plan:

a. Premiums not deductible. The law specifically forbids the deduction of premiums paid by a taxpayer on a policy covering the life of any officer, employee, or any person financially interested in its business, if the taxpayer is directly or indirectly a beneficiary under the policy.[34]

b. Proceeds not taxable income. On the other hand, the proceeds of a policy paid by reason of the insured's death are not regarded as taxable income in the hands of the recipient.[35]

c. Federal estate taxation. There are two categories of policies on the life of a decedent, the proceeds of which will be subjected to estate taxation in the decedent's gross estate: (1) proceeds of a policy payable directly to the insured's estate;[36] and (2) proceeds of a policy payable to beneficiaries other than the insured's estate, where the insured possessed at his death any incidents of ownership therein.[37] However, if the decedent died prior to August 16, 1954, the proceeds of a policy payable to a named beneficiary, with respect to which the decedent had directly or indirectly paid the premiums, must also be included in his taxable estate, regardless of whether he possessed the incidents of ownership.[38]

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[33] The provisions of the 1954 Code dealing with unrealized receivables and appreciated inventory items are applicable with respect to a partnership distribution occurring after March 9, 1954.

[34] 1954 IRC § 264(a)(1) and 1939 IRC § 24(a)(4). See also *Joseph Nussbaum*, 19 B.T.A. 868 (1930), in which each of two partners had insured his life for the benefit of the other, and paid the premiums on his own policy. The Board held that each partner was at least indirectly a beneficiary under such a reciprocal plan and therefore not entitled to deduct the premiums as an ordinary and necessary business expense within the meaning of Sec. 23(a) of the 1939 IRC.

[35] 1954 IRC § 101(a) and 1939 IRC § 22(b)(1).

[36] 1954 IRC § 2042 and 1939 IRC § 811(g)(1).

Giving due consideration to each of the factors mentioned above, there are two fundamentally desirable insurance arrangements for funding these agreements:

a. Cross insurance. This means that each stockholder or partner takes out an insurance policy on the other's life and agrees to apply the proceeds thereof toward the purchase price of the deceased's interest. The proceeds are payable directly to the survivors who pay all the premiums and exercise all incidents of ownership in the policy.

The significant advantages of such a cross-insurance plan are:

(1) For estate tax purposes, the decedent's gross estate does not include the proceeds of insurance, but only the fair market value of the decedent's business interest, a figure which ordinarily will be limited by the purchase price stipulated in the agreement.

(2) The proceeds of insurance are not subject to the claims of the decedent's creditors or his widow.

(3) Since the proceeds are to be paid directly to the survivors and applied by them toward the purchase price of the decedent's interest, they will, upon subsequent sale of that interest, have a cost basis which reflects the entire amount of the insurance. In cases where the insurance was payable directly to the decedent's estate in lieu of his business interest, the Courts have held that the proceeds may not be included in the survivor's cost basis.[39]

b. Policies owned and paid for by corporation. Where there are a number of stockholders to deal with, the simplicity of this plan makes it attractive. Here the proceeds of a policy on the life of a deceased shareholder are simply used to retire his stock. This type of arrangement has most of the good features of a cross insurance plan, plus the practical advantage, from the point of view of the stockholder, of not requiring that he dig into his pocket for personal funds, which have already been through the individual tax wringer, to pay the premiums on policies insuring the lives of his associates.

19. Uninsurable Stockholder or Partner

Occasionally, one of the prospective parties to the agreement is uninsurable. If this situation prevails, it is possible to compensate for the lack of insurance on his life by setting up a purchase fund into which a fixed sum will be deposited annually by either his partners, the other stockholders, or the corporation.

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[37] 1954 IRC § 2042.

[38] 1939 IRC § 811(g)(2).

[39] *Paul Legallet*, 41 B.T.A. 294 (1940), in which the proceeds were payable directly to the deceased partner's widow. The surviving partner subsequently contended that the insurance proceeds should be included in his income tax basis of the business interest. On the ground that the insurance proceeds had not been paid by the survivor to the estate, the Board held against him.

20. Specific Performance

In some cases,[40] the Treasury has contended that a stock purchase agreement is not effective to place a ceiling on the fair market value of the stock in question, because a court of equity could not order its specific performance. Actually, because stock in a close corporation is of an obviously unique and peculiar nature, such a decree could almost always be obtained. However, even though this Treasury argument has hitherto been rejected by the Courts, it is probably just as well to play safe by inserting a clause in the agreement expressly providing that specific performance of its terms is obtainable.

21. How to Fix the Terms Governing Value

a. Avoid ambiguity. This is the chief pitfall to be avoided in fixing the price at which the transaction is to be consummated upon the happening of the specified event. Failure to spell out clearly and concisely the manner in which the parties intend that value be determined will often defeat the very purpose of the agreement. Clarity and detail are of the essence.

b. "In accordance with accepted accounting principles." Many agreements are weighted down with long, involved discussions of relatively unimportant matters but dismiss the problem of arriving at the desired value with the words, "to be determined in accordance with accepted accounting principles." Except possibly in the simplest of situations, this is virtually a meaningless phrase. Even among certified public accountants, there are areas of disagreement on accounting principles, although in recent years the American Institute of Accountants, through its publications,[41] has brought about a greater degree of uniformity than had previously existed.

But more important, the average business man who seeks to state, as against another, a means of determining the price at which his business interest is to someday change hands, invariably has his own individual ideas with respect to the values which should be placed on the various assets comprising that interest. It is, therefore, far better to have a clear meeting of the minds on all of the details which will produce the ultimate figure, than to leave the matter up in the air by employing a phrase which most people believe to have a specific meaning, but which in many cases does not.

c. Consider realities. Consideration must be given to present realities as well as future possibilities. If a restrictive agreement is entered into at a time when a business is already well established, prosperous, and with years of history behind it, it is naive to draw the agreement as though you were dealing with a new enterprise whose future is dim and uncertain. On the other hand, if the agreement is drawn at the inception of an enterprise, although it is wise to consider certain of the more basic changes which may result from a successful operation, no useful purpose is served by going into minute details regarding remote contingencies. A simple, forthright, prudent view is generally the best one.

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[40] *Wilson* v. *Bowers* (2 Cir. 1932), 57 F. 2d 682, 11 AFTR 33; *Lomb* v. *Sugden* (2 Cir. 1936), 82 F. 2d 166, 17 AFTR 582.

[41] See *Accounting Research Bulletins* issued by the Committee on Accounting Procedure of the American Institute of Accountants, 270 Madison Avenue, New York City. These bulletins are published in pamphlet form.

d. Commence with book value. It is generally best to base the value on the books with certain adjustments. Keep in mind, though, that book value, in and of itself, is no criterion of fair market value. Very few, if any, securities traded in on an exchange are valued at book value. Such factors as earning power, history, and prospects of the business, and other influences too numerous to mention govern the day-to-day quotations. Unfortunately, however, none of us possess the occult powers required to foresee with exactitude the effect, if any, which each of such factors will have on the price to be paid for a business interest some years hence.

One does not know when he enters into this type of an agreement whether he will be the buyer or the seller. Hence, he cannot take the attitude he would if he knew on which side of the fence he was destined to ultimately stand. This uncertainty as to which of the parties to the agreement is eventually to be called upon to make the payment operates, or at least should operate, as the great leveler of those differences in viewpoint which generally arise when the parties endeavor to foresee the trend of future events in the business. In short, if they comprehend the situation clearly, the parties will usually be willing to "let the chips fall where they may," an attitude which will invariably set the stage for a fairly negotiated, arm's length agreement. All things considered, book value is as good a starting point as any.

However, book value need not, and often should not, be the final value. Much depends on how the books are kept. For example, certain assets may have been written down too rapidly or valuation reserves may have been set too high. Naturally, therefore, even though book value may be used for a starting point, the agreement must be more specific regarding the valuation of such assets.

e. Accounts receivable. The agreement should set forth the manner in which accounts receivable are to be reduced by reserves for bad debts and discounts, whether or not such reserves are maintained on the books. For instance, it may be advisable to provide that, irrespective of the amount of the reserve set up on the books, the reserve for bad debts is to be based upon the actual experience of the business over a given period immediately preceding the date on which the terms of the agreement are to be invoked.

f. Inventories. The agreement should state whether or not an inventory is to be taken as of the critical date, or whether adjustment shall be made to a prior inventory, and if so, how that adjustment shall be computed. Consideration should also be given to the question of how the inventory is to be valued (cost, cost or market, whichever is lower or higher, etc.), and how to treat obsolete material.

g. Depreciation. Fixed assets present problems in that the depreciation on the books may or may not be adequate. There are many concerns which set up on their books different rates of depreciation from what the Treasury Department allows for income tax purposes. The agreement should make it clear how these depreciation reserves are to be treated in arriving at the agreed upon value. Also, it is sometimes advisable to state in the agreement whether or not the fixed assets themselves are to be taken into account at book value or whether some other criterion, such as replacement value, is to be used.

h. Deferred charges and intangibles. It is especially important that the agreement should specifically state whether deferred charges, prepaid expenses, good will, and other intangibles are to be taken into account, and if so, how their value is to be ascertained. Among the assets of the business may be shares of stock that are not quoted or dealt in on an exchange or any other market. Carefully detailed provisions for the valuation of these intangible assets may avoid costly litigation and much disagreement between the parties.

i. Reserves for contingencies and uncompleted contracts. In certain businesses, it is always wise to indicate exactly to what extent reserves for contingencies are to be reflected in the final value, regardless of whether or not they appear on the books. If the nature of the business requires it, the agreement should provide an appropriate method of valuing uncompleted contracts. If this is not practical, the problem may be met with a provision to the effect that part of the purchase price be placed in escrow for a fixed period, until the contingencies have been resolved, or until work on the uncompleted contracts has been finished.

j. Amendments to agreement. You should leave no stone unturned in endeavoring to set forth in the agreement fully and fairly the present intent and understanding of the parties thereto. Still-in-all, no one can foresee all of the problems which may arise in any given business. Depressions, periods of inflation, and even personal circumstances all have their effect upon values. Consequently, it is essential that provision be made for amendment of the agreement any time conditions are such as to warrant a change. Moreover, in order to be certain that the occasion upon which such a change may be required does not slip by unnoticed, the parties concerned should regularly review the agreement, from time to time. In fact, it is advisable to have the agreement itself provide for the review of its terms and conditions at regularly stated intervals.

k. Arbitrators. Finally, no matter how precise you may have been in your initial draftsmanship, it is possible that a dispute will sometime arise as to the proper meaning and interpretation to be placed upon certain terms of the agreement. This contingency is taken care of with a provision for the appointment of arbitrators in the event of any dispute. The normal procedure is for one to be chosen by each of the adverse parties, and a third by the two so chosen.

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Tax Consequences of Covenants Not to Compete

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We are concerned here with the very narrow question of the tax consequences of an agreement by the seller of a going business to refrain for a given period from competing with the purchaser of the business. The question has two sides, the tax consequences to the *seller* and the tax consequences to the *buyer*. A lack of awareness of such tax consequences can be very costly to the seller or the buyer and it is important, therefore, that the tax counselor, if he is to protect and further the interests of his client, shall not overlook the dangers (for the seller) and the advantages (for the buyer) which are inherent in this situation.

Before beginning a detailed consideration of the problem, its essential nature may be indicated by the following:

1. Points to Consider

	Section
For the Seller:	
Will the inclusion of the agreement convert what otherwise would have been capital gain wholly or partially into ordinary income?	2, 3, 4, 5, 7
For the buyer:	
Can some part of the sales price be allocated to the agreement? If such allocation can be made, is the allocable part deductible as a business expense? Or must it be depreciated over the term of the agreement?	2, 3, 4, 6, 7
For both the seller and the buyer:	
What can be done in advance to secure the desired tax consequences?	8, 9

2. Preliminary Analysis of the Problem

Perhaps there is no easier way to highlight the questions involved than to sketch a situation in which such questions typically arise. Let us suppose that:

Hans Fritz is the owner of the Hans Fritz Delicatessen which he has operated, as sole proprietor, in a suburban community for more than twenty years. It is widely recognized that the Hans Fritz Delicatessen is the leading business of its type in the community. However, Mr. Fritz is getting old and wishes to sell his business and retire.

After receiving several offers, Mr. Fritz enters into a contract with Patrick Moriarity which provides that Mr. Fritz agrees to sell the delicatessen business and Mr. Moriarity agrees to buy it for $25,000. The contract also contains an agreement by Mr. Fritz not to engage in the delicatessen business for a period of ten years.

The sale is consummated in accordance with the terms of the contract. At the time of the sale, the inventory and all other tangible assets transferred to Mr. Moriarity had a fair market value of only $5,000.

This rather homely example enables us to state in the simplest terms the problems which confront the tax counselor if he is asked to pass on a contract of the type entered into by Messrs. Fritz and Moriarity.

The seller wants to know whether the profit realized by him upon the sale represents capital gain from the sale of a capital asset, or ordinary income. In order to answer this question, he will want to know, among other things, whether any part of the sale price has to be allocated to the agreement not to compete. He may also ask to what extent the parties have it within their control to determine the answer to this basic question. For example, will the tax consequences turn upon whether the agreement of sale does or does not state a separate, specific consideration for the agreement not to compete? Similarly, the buyer will want to know whether any part of the sale price may be allocated to the seller's agreement not to compete and, if so, whether he may deduct the part so allocable as a business expense or whether it must be considered as payment for an asset. If it is the latter, is depreciation allowable with respect to it?

3. The Toledo Newspaper Cases

An appreciation of the problems connected with agreements not to compete also may be obtained by the examination of a situation where both the seller and the buyer litigated the tax consequences of their sale and purchase. Such a situation was presented by the Toledo newspaper cases.[1]

The Toledo News-Bee and the Toledo Blade were competitors in the evening newspaper field. In order to eliminate the competition of the News-Bee, the Blade entered into an agreement with it under which the Blade acquired the right to use the News-Bee's name, its circulation, dealer and carrier lists and other assets, not including plant and equipment, for $100,000. In the same agreement, but in a separate paragraph, the News-Bee agreed to discontinue publication for a period of ten years for a further consideration of $780,000.

The seller, who had agreed not to compete, was the first one to litigate the tax consequences of the arrangement.[2] The Commissioner contended that the seller had received $780,000 for its agreement not to compete and that this amount represented ordinary income. However, the Tax Court found as a fact that the agreement not to compete was necessary in order to prevent the seller from destroying the value of the good will of the business transferred and held that the entire consideration received by the seller was to be treated as a whole in computing gain from the sale and that such gain, if any, was capital gain.

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[1] *Toledo Blade Co.*, 11 T.C. 1079 (1948), affirmed (6 Cir. 1950), 180 F. 2d 357, 39 AFTR 7, cert. den. 340 U.S. 811, (1950), Acq. 1949-2 C.B. 3; *Toledo Newspaper Co.*, 2 T.C. 794 (1943). Another starting place could have been the companion cases of *Gazette Telegraph Co.*, 19 T.C. 692 (1953), affirmed (10 Cir. 1954) 209 F. 2d 926, 45 AFTR 266, and *Hamlin Trust*, 19 T.C. 718 (1953), affirmed (10 Cir. 1954) 209 F. 2d 761, 45 AFTR 224. These cases also involved the sale of a newspaper (through the sale of stock rather than assets, however). A separate consideration was stated in the contract for the covenant not to compete and the Tax Court held (a) that the buyers could amortize said amount over the term of the covenant; and (b) that the sellers realized ordinary income to the extent of the amount allocated to the covenant.

Five years later, the buyer went to the Tax Court claiming that it was entitled to amortize the $780,000 paid the seller for the agreement not to compete over the ten-year period of the agreement.[3] The Tax Court, consistently with its previous interpretation, held that the agreement of sale was not separable and that the total consideration, i.e., $880,000 was the price paid for the going business and intangible assets, including the good-will and the agreement not to compete. Therefore, amortization deductions with respect to the claimed cost of the agreement not to compete were not allowable.

4. General Rules

With this typical controversy as a background, we can examine the general rules which are said to be determinative in this situation. One of the most concise statements of the general rule as to the consideration received for an agreement not to compete is contained in *Aaron Michaels,*[4] where the Tax Court stated:

> If such an agreement (i.e. not to compete) can be segregated, not so much for purposes of valuation, as in order to be assured that a separate item has actually been dealt with, the agreement is ordinary income and not the sale of a capital asset. . . . But where it accompanies the transfer of good-will in the sale of a going business and it is apparent that the covenant not to compete has the function primarily of assuring to the purchaser the beneficial enjoyment of the good will which he has acquired, the covenant is regarded as nonseverable and as being in effect a contributing element to the assets transferred.[5]

Similarly, by paraphrasing this statement of the rule with respect to the seller, the general rule as to the consideration paid for an agreement not to compete may be stated as follows:

If an agreement not to compete can be segregated, the amount paid therefor may be deducted by way of depreciation over the period of the agreement; but where the agreement not to compete accompanies the transfer of good will in the sale of a going business and it is apparent that the covenant not to compete has the function primarily of assuring to the purchaser the beneficial enjoyment of the good will which he has acquired, the purchaser may not deduct by way of depreciation the claimed cost of the agreement.

With these general rules in mind, we may note briefly some of the cases in which they have been applied.

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[2] *Toledo Newspaper Co.; supra,* note 1.

[3] *Toledo Blade Co., supra,* note 1.

[4] *Aaron Michaels,* 12 T.C. 17 (1949), Acq. 1949-1 C.B. 3.

[5] 12 T.C. 17, 19 (1949).

5. Tax Consequences to Seller

We have said that if the agreement not to compete is inseparable from a transfer of good will—is in fact a part of the good will itself—the maker of the agreement will not be deemed to have received any consideration taxable as ordinary income for his agreement. Typical of the cases following this rule is *Aaron Michaels, supra.*[6] In that case, the taxpayer had sold for $9,000 a linen supply business consisting of supplies worth approximately $1,500, lists of customers and good-will, and had agreed not to compete with the purchaser for a period of five years. The Tax Court, after finding as a fact that the agreement not to compete was an integral part of the good-will, held that the entire proceeds of the sale, exclusive of that part attributable to the supplies, was taxable at capital gains rates.[7]

On the other hand, we stated that if the agreement not to compete can be separated from the transfer of good-will, and a determination can be made as to the consideration paid for the agreement, the amount of such consideration is taxable to the recipient as ordinary income. This rule is illustrated by the case of *George Prince.*[8] There, the taxpayer received $130,000 from a city which was about to construct a toll bridge in return for his agreement to discontinue operation of a ferry and his promise to refrain from competing with the bridge. The taxpayer claimed that the $130,000 was taxable at capital gain rates, arguing that he had sold good-will and other intangible assets. The Board of Tax Appeals, after pointing out that good-will existed only with reference to a going business and that neither the business nor the assets of the ferry company had been sold, held that the $130,000 was ordinary income to taxpayer.[9]

6. Tax Consequences to Buyer

Toledo Blade Co., supra,[10] is illustrative of the rule that where the agreement not to compete is not severable from the transfer of good-will, the buyer will not be allowed to amortize his alleged cost over the period of the agreement. Similarly, in *Market Supply Co.,*[11] the Board of Tax Appeals held that where a business was sold for a stated amount above the value of inventory and the seller agreed not to compete, this amount was not deductible by the purchaser since it was impossible to segregate the consideration paid for the agreement not to compete.[12]

On the other hand, if the agreement not to compete is not an integral part of a transfer of a going business and its good-will, a series of cases, typified by *Christen-*

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[6] 12 T.C. 17 (1949).

[7] See also *Toledo Newspaper Co., supra,* footnotes 1 and 2.

[8] Par. 42,238 Prentice-Hall Memorandum B.T.A. (1942).

[9] See also *Estate of Mildred K. Hyde,* 42 B.T.A. 738 (1940); *Beals' Estate* v. *Commissioner* (2 Cir. 1936), 82 F. 2d 268 and *Cox* v. *Helvering* (App. D.C. 1934), 71 F. 2d 987. In the *Beals' Estate* case, the Court said: "A promise not to work for others or for oneself is no more a conveyance of property than is a promise to enter the promisee's employ. Payment for either promise is income, not proceeds received on disposal of a capital asset." (p. 270).

[10] 11 T.C. 1079 (1948).

[11] 3 B.T.A. 841 (1926).

[12] See also *R. Bryson Jones,* 17 B.T.A. 1213 (1929).

sen Machine Co.,[13] indicates that the consideration paid for the agreement may be deducted ratably over the period of the agreement. In that case, the taxpayer entered into an agreement with one of its stockholders under which the stockholder agreed to sell his stock to taxpayer and not to compete with taxpayer in consideration of the payment of $60,000. The Board found that $30,000 was the fair value of the stock transferred and permitted the taxpayer to amortize the remainder of the $60,000 over the period of the agreement not to compete.[14]

7. Basic Question in Determining Tax Consequences

An analysis of the cases discussed above and other cases of the same type points to the conclusion that in determining the tax consequences of an agreement not to compete, a determination first must be made as to whether the agreement was separately bargained for and sold or was merely incidental to and in furtherance of the sale of a business and its good will, i.e. "the covenant not to compete is really good-will under a different name." [15] Admittedly it is not always easy to determine whether an agreement not to compete is merely a part of a transfer of good-will. The cases seem to justify the conclusion that whenever the agreement is made in connection with the transfer of the assets of a going business, the agreement will not be considered a separate item.[16] And this is true even though the parties, as in the Toledo newspaper cases, supra, specifically allocate a part of the consideration to the agreement not to compete in their agreement of sale. It is only where the agreement is given in connection with an occurrence other than the sale of the assets of a business or where the party agreeing to refrain from competing is not the seller that the agreement will be considered a separate item for which a separate consideration was paid.[17] In only three cases do there appear to have been possible deviations from these conclusions.

In *Rodney B. Horton*,[18] the taxpayer, a certified public accountant, sold his business to another accounting firm and agreed not to compete for six years. The physical assets of the business were paid for in cash and the taxpayer was to receive a certain percentage of all fees obtained by the purchaser during a five-year period. The taxpayer reported this percentage of fees as an amount received from the sale of good-will, taxable as a capital gain. The Tax Court found, however, that the percentage payments were severable and held that 50 per cent of such payments was made in consideration of good-will transferred and the remainder was made in consideration of the agreement not to compete. Thus, the Court held that the agreement not to compete was separate from the transfer of good-will even though made by the seller in connection with the sale of his business. The case probably is explicable on the basis of a provision in the contract of sale providing for a 50 per cent reduction in the amount of the percentage payments to the seller in the event of his removal from the area in which he had promised not to compete or in the event of his death. The Court may well have felt that this clearly indicated an intent to deal with the agreement not to compete as a separate item.

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[13] 18 B.T.A. 256 (1929).

[14] See also *Eitingon-Schild Co.*, 21 B.T.A. 1163 (1931); *News Leader Co.*, 18 B.T.A. 256 (1929), and *Black River Sand Corporation*, 18 B.T.A. 490 (1929), Acq. IX-2 C.B. 44 (1930).

[15] See rewrite Bulletin, "Covenants Not to Compete." 495 C.C.H. Standard Federal Tax Reports, par. 8742.

[16] See cases cited in footnotes 1, 4 and 12, supra.

[17] For cases where the maker of the agreement not to compete was the taxpayer, see: *Hamlin Trust*, 19 T.C. 718 (1953), affirmed (10 Cir. 1954) 209 F. 2d 761, 45 AFTR 224; *George Prince*, par. 42,238 Prentice-Hall Memorandum B.T.A. (1942) (agreement to discontinue ferry route; no transfer of assets or business); *Estate of Mildred K. Hyde*, 42 B.T.A. 738 (1940) (no transfer of assets or business; agreement part of separation agreement); *Beals' Estate* v. *Commissioner* (2 Cir. 1936), 82 F. 2d 268, 17 AFTR 621 (agreement made by officer of corporation transferring its assets and business); and *Cox* v. *Helvering* (App. D.C. 1934), 71 F. 2d 987, 14 AFTR 359 (agreement made by principal stockholder of corporation transferring its assets and business). For cases where the promisee was the taxpayer, see: *Gazette Telegraph Co.*, 19 T.C. 692 (1953), affirmed (10 Cir. 1954) 209 F. 2d 926, 45 AFTR 266; *Eitingon-Schild Co.*, 21 B.T.A. 1163 (1931) (agreement given by stockholder in connection with sale of his stock; no sale of business); *News Leader Co.*, 18 B.T.A. 256 (1929) (no sale of assets or business); *Christensen Machine Co.*, 18 B.T.A. 256 (1929) (agreement given in connection with sale by principal stockholder of his stock); and *Black River Sand Corporation*, 18 B.T.A. 490 (1929), Acq. IX-2 C.B. 44 (1930) (agreement made in connection with contract providing for retirement benefits).

[18] 13 T.C. 143 (1949), non acq. 1949-2 C.B. 4.

In *Carboloy Co., Inc.*,[19] taxpayer purchased the business of a sales agency. Article I of the contract of sale provided for the conveyance, in consideration of the payment of $13,500, of the entire business and good-will of the seller. Article 3 of the contract of sale provided for periodic payments to the seller over a period of seven years, the payments to be made only if, on each payment date, the seller was not engaged in competition with the buyer. The Tax Court held that Articles 1 and 3 were independent and that the payments specified in Article 3 were for refraining from competition and, therefore, the buyer was entitled to deduct them either as ordinary and necessary business expenses under Section 23(a) of the 1939 Internal Revenue Code or ratably over the life of the agreement not to compete under Section 23(1). The *Carboloy Co.* case, therefore, represents a second instance in which an agreement not to compete was considered separate even though made by the seller concurrently with the sale of a going business. Here a separate consideration was stated for the agreement not to compete but we have seen in the Toledo newspaper cases that this is not necessarily decisive. The Court seemed to be impressed with the fact that the payments under Article 3 would cease if the seller broke his promise not to compete and, on this ground, the *Carboloy Co.* case may be distinguishable from the Toledo newspaper cases where the alleged payment for the covenant not to compete was made in a lump sum in advance.

In *B. T. Babbitt, Inc.*,[20] the taxpayer, pursuant to the terms of a contract of sale, purchased the business and good will of the seller for a stated consideration. The stock on hand was purchased for a separate consideration. The contract also provided that in consideration of "the considerations hereinbefore expressed," the seller would refrain from competition for a stated period. The Board of Tax Appeals found that the value of the covenant not to compete was not less than 85 per cent of the consideration paid for the business and held that the taxpayer was entitled to deduct this amount ratably over the period of the agreement not to compete. This case is more extreme than either the *Horton* or *Carboloy Co.* cases, *supra*, for here no effort was made by the parties to state a separate consideration for the agreement not to compete. The Board, however, went behind the provisions of the contract and based its decision upon "uncontradicted evidence" that the agreement not to compete had a substantial value and that the other assets acquired had very little value. The Board also said that the primary object of the buyer in entering into the contract was the elimination of the seller's competition.

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[19] Par. 43,325 Prentice-Hall Memorandum T.C. (1943).

[20] 32 B.T.A 693 (1935).

8. Statement of Separate Consideration for Agreement

To what extent can the impact of the general rules discussed above be affected by the statement in the contract of sale of a separate consideration for an agreement not to compete? We have already seen that the Tax Court gave no weight to such a statement of separate consideration in the Toledo newspaper cases, *supra.*[21] On the other hand, the statement of a separate consideration in *Carboloy Co., Inc., supra*[22] may have contributed to the result in that case.

One other case is worthy of notice in this context. In *Eitingon-Schild Co.*,[23] the taxpayer entered into a contract with an individual under which the latter agreed to sell certain stock owned by him and also to refrain from competition with the taxpayer. The contract had separate paragraphs covering the stock purchase and the agreement not to compete and stated that such paragraphs were "entirely distinct." Separate considerations also were stated. The Board of Tax Appeals held that the stated consideration for the agreement not to compete was deductible either as a business expense or by way of depreciation over the period of the agreement. The Board apparently was impressed by the separate treatment of the agreement not to compete for it said:

> The petitioner . . . paid a definitely specified consideration for Ahearn's covenant not to enter into competition. The fact that provisions constituting in effect two separate contracts were embodied in one written instrument is not material. The provisions of the contract are clear on this point, and specifically indicate that the consideration paid for the stock was "entirely distinct" from the consideration paid for the contract.[24]

No definite conclusion can be drawn from these cases as to the importance or efficacy of separate treatment, including the statement of a separate consideration, of an agreement not to compete. All of the cases could have been decided the same way without the separation of the agreement from the rest of the contract. In the Toledo newspaper cases, the Court apparently felt that the agreement not to compete had no value apart from the transfer of the good-will and, therefore, refused to be influenced by the parties' attempt to segregate the agreement. In the *Carboloy Co.* case, the Court probably was as much influenced by the fact that good will was not an important factor in the business transferred as it was by the separate treatment of the agreement not to compete. Similarly, the *Eitingon-Schild* case might have reached the same result without separate paragraphs since there the agreement not to compete was given in connection with the sale of stock, and not in connection with the sale of a going business and its attendant good-will.[25]

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[21] See footnote 1, *supra.* The Court may have been influenced by the provision of the contract under which it was agreed that the seller was to share in any tax savings to the buyer from deductions with respect to the seller's agreement not to compete.

[22] Par. 43,325 Prentice-Hall Memorandum T.C. (1943).

[23] 21 B.T.A. 1163 (1931).

[24] 21 B.T.A. 1163, 1181.

9. Conclusion and Practical Suggestions

In summary, the following general rules may be restated:

1. If the agreement not to compete is given as an incident and as a part of the contract for the sale of a going business, the agreement not to compete will not be deemed to have an independent value upon which the maker of the agreement will be taxed at ordinary income tax rates; similarly, the recipient of the promise will not be permitted to depreciate its alleged cost.
2. Where, however, the agreement not to compete is not an incident to or part of the contract for the sale of a going business, the consideration paid for this promise is ordinary income to the maker of the promise; similarly, the promisee may deduct such consideration by way of depreciation over the period of the agreement.

Finally, a few practical suggestions as to what the parties may do to improve their chances of achieving a desired result in this situation may be given:

1. If you are the seller and the maker of the promise not to compete, resist all efforts of the buyer to state a separate consideration for your agreement not to compete; conversely, if you are the buyer, insist upon stating in the contract of sale a separate consideration for the agreement not to compete.
2. If you are the buyer and hope to depreciate your cost of the agreement not to compete, make a full, contemporaneous record to show that you bargained for and purchased the agreement as a separate item. Also, make whatever record is possible to show that the agreement not to compete had an independent value and that you paid the amount of such value in consideration of the agreement.
3. If you, as the buyer, find yourself in litigation over your right to depreciate your alleged cost of an agreement not to compete, be sure to introduce evidence as to the separate value of the agreement; conversely, if you are the seller and the Commissioner of Internal Revenue is asserting that you realized ordinary income from your agreement not to compete, you should introduce evidence to show that your agreement had no independent value.

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[25] Cf. *Christensen Machine Co., supra,* footnote 13.

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How and When to Be a Dealer, Trader, or Investor

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Significant Federal income tax consequences flow from a classification as a "dealer," "trader," or "investor" in securities. The distinction among these classes depends upon all the facts involved, and qualification as one or the other is thus not wholly within the control of the taxpayer, Nevertheless, the tests that have been applied in the past point to the road that must be followed to arrive at one category or the other. This problem is described in this chapter.

1. Points to Consider

The most important question to decide is whether or not the taxpayer is a dealer, inasmuch as investors and traders are similarly treated for Federal income tax purposes, except with respect to wash sales. You must determine:

	Section
How to tell a dealer from an investor or trader	2
How to tell a trader from an investor	3

The answer to the basic question of whether a taxpayer is a dealer involves various factual considerations, the chief of which are:

	Section
Maintenance of a supply of securities	2
Purpose of business is to make a distribution profit rather than a speculative profit	2

Other factors that tend to establish a dealer status are that:

	Section
Sales are generally made in lots that are smaller than purchased lots, and the sales are to customers: to the public, to other dealers, or to brokers, who act either as principals or as agents for undisclosed principals	2
An established place of business and maintenance of a sales force	2
Holding oneself out as a dealer, that is, in advertisements, on letterheads, in listings, in trade publications, in a telephone directory, and on one's income tax return	2
Securing a license to deal in securities where local law requires license	2

After determining into what category your client falls, you may wish to attempt to change his status as to some or all of the securities held. The problems incident to this are covered as follows:

Section
May a taxpayer be both a dealer and trader or investor as to the same securities? 4
May a taxpayer be both a dealer and trader or investor as to different securities? 4
May securities originally acquired in one status be shifted to another status? 4

The above points are important in relation to the varying tax consequences that are set forth in the chart in Appendix A and that constitute the following:

Gain and loss on sale of securities 5
Inventories 6
Amortization of bond premium 7
Commissions on the purchase and sale of securities 8
Stamp taxes 9
Short dividends and premiums 10
Wash sale losses 11

2. How to Tell a Dealer from an Investor or Trader

A dealer differs from an investor or trader in the nature of his activity. Although many factors enter into determining whether one's activities constitute one a dealer, probably the most significant is the maintenance of a supply of securities with the intention of selling them for a distribution profit rather than a speculative profit.[1] An examination of the Regulations[2] and cases[3] indicates that these factors alone establish the existence of a dealer status. The other factors, which will be discussed, are but evidence of such status, insufficient in themselves to establish it.

The term "dealer in securities" is not defined in the Code. However, the regulation[4] that discusses the right to use inventories defines a dealer in securities as set forth below. This definition has usually been held applicable regardless of how the question of "dealer" status arises:[5]

> For the purpose of this rule a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly

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[1] *Helvering* v. *Fried*, 299 U.S. 175, 18 AFTR 621 (1936); *Schafer* v. *Helvering*, 299 U.S. 171, 18 AFTR 619 (1936); *Seeley* v. *Helvering* (2 Cir. 1935), 77 F. 2d 323, 15 AFTR 1402; *Commissioner* v. *Stevens* (2 Cir. 1935), 78 F. 2d 713, 16 AFTR 456; *Harriman National Bank* v. *Commissioner* (2 Cir. 1930), 43 F. 2d 950, 9 AFTR 207; *Squire* v. *Denman*, 18 F. Supp. 287, 18 AFTR 1269 (1936); *U.S.* v. *Chinook Investment Co.* (9 Cir. 1943), 136 F. 2d 984, 31 AFTR 246; *Harry Dunitz*, 7 T.C. 672 (1946); *Logan & Kanawha Coal Co.*, 5 T.C. 1298 (1945).

[2] Reg. 118, § 39.22(c)-5; Reg. 118, § 39.502-1; Reg. 118, § 39.332-1; see footnote 4, below.

[3] See cases cited in footnote 1, above.

[4] Reg. 118, § 39.22(c)-5. For the purposes of personal holding company classification "regular dealer in stock or securities" means "corporations with an established place of business regularly engaged in the purchase of stock or securities and their resale to customers, but such corporations are not dealers with respect to stock or securities held for speculation or investment." This definition has been held *in pari materia* with that relating to inventories. *Trading Associates Corp.* v. *Magruder* (4 Cir. 1940), 112 F. 2d 779, 25 AFTR 290. See also Reg. 118, § 39.332-1(e), dealing with foreign personal holding companies.

[5] *Donander Company*, 29 B.T.A. 312 (1933); *Van Suetendael* v. *Commissioner* (2 Cir. 1945), 152 F. 2d 654, 34 AFTR 638; *Warren* v. *U.S.*, 53 F. Supp. 578, 32 AFTR 297 (D.C.D. Mass. 1944). But see *U.S.* v. *Chinook Inv. Co.*, footnote 1, above.

engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.

The principal tests set up in the regulation are as follows:

1. A merchant of securities
2. An established place of business
3. Regularly engaged in the purchase of securities and their resale to customers
4. Buying and selling with a view to the gains and profits derived therefrom, and not for investment or speculation.

A typical example of such a merchant is an underwriter of securities who individually, or as a member of an underwriting syndicate, purchases large blocks of securities and sells them in wholesale or retail lots.

On the other hand, neither a stock broker[6] nor a "floor trader" [7] who merely acts as agent for others in the purchase and sale of stocks is a dealer even though he is regularly engaged in such activity. Nor is a stockbroker a merchant when he buys and sells securities on his own account "solely in expectation of a rise in the market, for sale to anyone at a profit, 'as distinguished from a purchase to create a stock of securities to take care of future buying orders in excess of selling orders.' " [8]

Contrasted with these is the decision of the Supreme Court in *Helvering* v. *Fried*, where it held a specialist on the floor of the Stock Exchange to be a dealer with respect to those stocks in which he is such specialist on the basis of the four tests in the regulation set forth above.[9]

The significance of this holding is made clearer by a consideration of the nature of the activities of a specialist that are delineated in *Vaughan* v. *Commissioner*.[10] There the court pointed out that a specialist, at his designated "post" on the floor of the Stock Exchange, makes a market for stocks by keeping a record of all offers and bids for the stock in which he specializes. These offers and bids are ordinarily made by other members of the Exchange. Where the bid and asked prices thus furnished coincide, a specialist matches one transaction against the other. The specialist is charged with the responsibility of maintaining an orderly market and is required to be ready at the demand of other brokers to quote the market price and to buy and sell at the closest fluctuations possible. Where there is too wide a "spread" between the "bid" and "asked" prices, in order to create a market, he either buys or sells the stock for his own account. In connection with such activity the specialist sometimes carries stock of his own, so that when the stock sells at less than the price offered, he has it available for delivery and does not have to sell short or borrow the stock.

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[6] *Hammitt* v. *Commissioner* (3 Cir. 1935), 79 F. 2d 494, 16 AFTR 806.

[7] *Seeley* v. *Helvering* (2 Cir. 1935), 77 F. 2d 323, 15 AFTR 1402.

[8] *Schafer* v. *Helvering*, 299 U.S. 171, 18 AFTR 619 (1936).

[9] *Helvering* v. *Fried*, 299 U.S. 175, 18 AFTR 621 (1936).

[10] (2 Cir. 1936), 85 F. 2d 497, 18 AFTR 455; cert. den. 299 U.S. 606 (1936).

What then is the distinction between the "specialist," who is a dealer in securities, and the stock broker, trading on his own account, who is not such a dealer? The buying and selling of securities may be the only occupation of the trader. He may have an established place of business and may rapidly turn over securities for a small margin of profit. In a sense, he may even be considered to have a "stock in trade" arising from repurchase by him of securities immediately after he has sold them. The merchant analogy used in the regulations seems to furnish the answer. A retail merchant, such as a grocer,[11] must keep goods on his shelf to sell to his customers. His store must be open during business hours. He must satisfy, as to considerations of price, those who buy from him. He is an established middleman in the distribution of groceries, and getting and keeping customers are his chief concern. He makes a volume profit on the turnover of his stock in trade. Similarly, a specialist must keep on hand his wares, the stocks in which he specializes, in order to perform his function in making a market, and in order to fill the needs of his customers. His purchases are made with the purpose of satisfying such needs. He regularly does this for the profit involved in distributing. On the other hand, a trader *may* perform these functions but there is no business necessity for him to do so; he does not need to satisfy customers in order to operate profitably.

The unavoidable element of investment or speculation in every purchase of property by a dealer[12] complicates the essentially factual question: Who is such a dealer? The mere fact that one has held himself out to the public as a dealer, for example, on his stationery, his advertisements, his listings in trade publications or on the telephone, and in his tax returns will not conclusively establish a dealer status. But these representations will influence the determination of whether or not the purchase of securities was for purposes of resale to customers or for investment and speculation.[13] Accordingly, a taxpayer who wishes to avoid classification as a dealer should carefully check each of them.

3. How to Tell a Trader from an Investor

Activities in buying and selling securities will constitute one a trader rather than an investor where these activities are "such that they may, of themselves, be regarded as a regular occupation for the purpose of livelihood or profit." [14] Of course, where the activity constitutes taxpayer's main source of livelihood and most of his working time is devoted to it, a clear example of a trader is found. Where the taxpayer is engaged in more than one trade or business, such factors as the frequency and regularity of the transactions, the amount of his income derived therefrom, and the amount of time devoted to the transactions all must be examined in order to determine whether taxpayer is a trader.[15] An extremely wealthy person might have transactions in an aggregate money value far greater than a trader of moderate means and these transactions might be regular and frequent. Nevertheless, he might be held an investor because only a small proportion of his time was devoted to security transactions and only a small portion of his total income derived therefrom.

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[11] See *United States* v. *Chinook Inv.* Co. (9 Cir. 1943), 136 F. 2d 984, 31 AFTR 246, comparing the carrying on of a business as a dealer in securities with that of "a dealer of hogs or cattle or town lots, finding its customers where it could." See also *Seeley* v. *Helvering*, footnote 7, above ("a merchant, ordinarily at least, does not resell to the same class of persons from whom he buys").

[12] *United States* v. *Chinook Inv. Co.*, footnote 11, above.

[13] *Stokes* v. *Rothensies*, 61 F. Supp. 444, 34 AFTR 180, affirmed. (3 Cir. 1946), 154 F. 2d 1022, 34 AFTR 1174; *Wilson* v. *Commissioner* (10 Cir. 1935), 76 F. 2d 476, 15 AFTR 1156; *Ethel S. White*, 1947, par. 47,262, Prentice-Hall Memorandum T.C.

[14] *Oscar E. Rehm*, 21 B.T.A. 243 (1930).

4. Activities as Both Dealer and Trader or Investor

There are numerous examples of a taxpayer's occupying a dual relation to the same security. A dealer may invest surplus funds in the same security in which he deals. An underwriter may, as a member of an underwriting syndicate, acquire some securities for distribution to customers as a dealer and another block of the same securities as an investor under an agreement to hold that block until the rest of the issue has been marketed. The underwriter may also, as a participant in a syndicate, "take down" its participation and become an investor in the securities in which it had previously dealt as a syndicate participant. Banks may have securities in their investment portfolio that are of the same type as securities in which they are recognized dealers. Both the regulations[16] and decided cases[17] concede that a taxpayer may be classified as both a dealer and a trader or investor in securities and this dual status may be occupied as to securities of the same type. He may even sell investment securities to the customer to whom he sells his stock in trade. Prior to the enactment of the Revenue Act of 1951 there was sometimes considerable difficulty for a dealer who wanted to prove (when a security was sold at a gain) that the profitable transaction was the sale of a capital asset. On the other hand where a security was sold at a loss, the Government might resist a claim by a dealer that the security was held for sale to customers, particularly in cases where there had been a switch in the status of the security during the holding period from investment account to inventory.[18] In an attempt to clarify this situation, Section 1236 of the Code was added by the Revenue Act of 1951. Section 1236 also prevents switching between inventory and investment account for tax purposes. The rules apply to sales or exchanges made after November 19, 1951.

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[15] *Sol H. Morris*, 38 B.T.A. 265 (1938); *Richard Coulter*, 32 B.T.A. 617 (1935); *Oscar E. Rehm*, footnote 14, above. *Richard D. Wyckoff*, 19 B.T.A. 263 (1930); *George P. Sacks*, 25 B.T.A. 415 (1932).

[16] Reg. 118, § 39.22(c)-5, footnote 4, above, after referring to inventory methods and defining the term "dealer" states: "If such business [of a dealer] is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment."

[17] *Vaughan* v. *Commissioner* (2 Cir. 1936), 85 F. 2d 497, 18 AFTR 455, cert. den. 299 U.S. 606 (1936); *Harriman National Bank* v. *Commissioner* (2 Cir. 1930), 43 F. 2d 950, 9 AFTR 207; *Fried* v. *Commissioner* (2 Cir. 1936), 83 F. 2d 193, 17 AFTR 946, affirmed *sub nomine*; *Helvering* v. *Fried*, 299 U.S. 175, 18 AFTR 621 (1936); *Hammitt* v. *Commissioner* (3 Cir. 1935), 79 F. 2d 494, 16 AFTR 806.

[18] *Pacific Affiliate, Inc.*, 18 T.C. 1175 (1952), N.A. (in part) 1953-2 C.B. 8; *E. Everett Van Tuyl*, 12 T.C. 900 (May 31, 1949) (A. 1949 I.R.B. No. 20); *Carl Marks & Co. Inc.*, 12 T.C. 1196 (1949); I.T. 3891, 1948-1 C.B. 69; see also cases cited in footnote 17, above; compare I.T. 3828, 1946 2 C.B. 68 (modified as to requirements 1 and 2 listed below by I.T. 3891) wherein the Bureau had taken the position that even a decision by a dealer at the time of acquisition to treat securities as an investment was ineffectual unless the following requirements were met: (a) The securities were acquired and held under substantially different circumstances

Gains by a dealer in securities from the sale or exchange of any security are in no event to be considered as gain from the sale or exchange of a capital asset unless (1) within thirty days from the acquisition of the security, it was clearly identified in the dealer's record as a security held for investment, and (2) the security was not, at any time after the expiration of the thirty day period held by the dealer primarily for sale to customers in the ordinary course of his business.[19] On the other hand, losses by a dealer in securities from the sale or exchange of any security are not considered as losses from the sale or exchange of noncapital assets if at any time after the thirty day period the security is clearly identified in the dealer's records as a security held for investment.

Section 1236 is a one way street for the Government.[20] The Government may claim that a security identified as an investment is in fact held for sale to customers in cases of sales at profit. On the other hand, the dealer is bound by his own characterization as an investment where a security is sold at a loss. Nevertheless, Section 1236 is explicit Congressional sanction for the dual status of dealer and investor and the way is eased for dealers who identify according to its provisions.

The Commissioner's regulations require an actual accounting separation of the investment securities from other securities.[21] This means that book entries must show that the particular security is distinguished from inventories and that it is carried as an investment by the dealer. Moreover, the entries must show, to the extent feasible, the individual serial number or other characteristic symbol of the security. The regulations state that the thirty day identification period starts with the day following the date of acquisition.[22]

Prior to the 1951 Act it was held in the *Wood* case that if a dealer ceases to be a dealer his securities are to be treated as capital assets even though no transfer was made from inventory to investment account.[23] It would seem that the same rule should apply now, since by its terms Section 1236 applies only to gains or losses "by a dealer in securities."

It should be noted that banks, under Section 1236,[24] treat losses from the sales of bonds, notes, debentures, etc. as ordinary losses while the aggregate of losses on such sales in a taxable year exceed the total gains.[25]

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than securities regularly dealt in. (b) The securities were of a type different from those dealt in. (c) The securities were segregated in a separate account and not intermingled with securities held as a dealer. (d) It was indicated at the time of purchase that the securities were acquired for investment; see: Senate Finance Committee Report No. 781 on H.R. 4473 (Revenue Bill of 1951) at VI-4.

[19] For the purposes of Section 1236 the term "security" refers to any share of stock, certificate of stock or interest in any corporation, note, bond, debenture, evidence of indebtedness or any evidence of an interest in or right to subscribe to or purchase any of such securities.

[20] See Senate Finance Committee Report, footnote 18, above.

[21] Reg. 118, § 39.117(n)-1(c).

[22] id.

[23] *Austin Bertrand Wood, et ux* v. *Com.*, 197 F. 2d 859 (1952), aff'g T.C. Memo. Dec. 50048 (1950).

[24] IRC § 1236(b).

[25] IRC § 582(c).

5. Gain and Loss on Sale of Securities

Since securities dealt in by a dealer are not capital assets, gains and losses on the sale or exchange thereof are ordinary income and deductions.[26] Thus, any net loss is not only fully deductible in the year in which it is suffered, but is includible without limitation in the net operating loss carry-back or carry-forward.[27] The tax advantages arising from this rule are readily apparent when comparison is made with the treatment of sales or exchanges of securities by a trader or investor, for tax purposes. Although gains realized on such sales are taxed at capital gain rates, any net capital loss in the case of a corporation is not deductible against ordinary income. In the case of an individual, any net capital loss is deductible only against ordinary income to the extent of $1,000 or other net income, whichever is smaller. In turn, any net capital loss carried over is deductible only in the case of a corporation against future capital gains, and, in the case of an individual, against such gains, and also to the extent of $1,000, or other net income, whichever is smaller.[28]

Moreover, gains from the sale or exchange of stock or securities by a dealer are not personal holding company income for the purpose of determining whether a corporation is a personal holding company.[29]

6. Inventories

Section 471 gives to the Commissioner the power to define the conditions under which property may be included in inventory. The regulations[30] limit the right to inventory securities to dealers in securities, and provide that such dealers may inventory unsold securities on hand either at cost; at cost-or-market, whichever is lower; or at market. See discussion in Section 7 below. A dealer may make a return upon that basis, provided such method is used for all such securities, is indicated in the tax return, and is adhered to for subsequent years.

Failure of a dealer to comply with the requirement of the regulation relating to the inclusion in his return of a description of the accounting method employed has been held not to preclude him from employing the inventory method when there is substantial compliance with the regulations and he has previously used the inventory method in keeping his books. As a practical matter, however, it is advisable to designate on the return the method that has been used.[31]

Since traders and investors may not inventory their securities, gains or losses resulting from sales or exchanges must be accounted for on a transaction-by-transaction basis. If the identity of the securities can be determined, the trader or investor must account for the transaction on the basis of the actual identification. If, however, the securities are sold from lots purchased on different dates or at different prices and the identity of the lots cannot be established, a sale of securities is charged against the earliest purchases of the type of securities sold. The first-in-first-out rule is used only where all other methods of identification fail.

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[26] IRC § 1221 excludes from the definition of "capital assets" "stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer . . . or *property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.*" (Emphasis supplied.) *United States* v. *Chinook Inv. Co.* (9 Cir. 1943), 136 F. 2d 984, 31 AFTR 246; *Harry Dunitz,* 7 T.C. 672 (1946), affirmed (6 Cir. 1948) 167 F. 2d 223, 36 AFTR 934; *Vance Lauderdale,* 9 T.C. 751 (1947).

[27] IRC § 172.

[28] IRC § 1211.

[29] IRC § 543(a)(2). See also footnote 4, above.

[30] Reg. 118, § 39.22(c)-5.

[31] *Commissioner* v. *Stevens* (2 Cir. 1935), 78 F. 2d 713, 16 AFTR 456, cert. den. 299 U.S. 606 (1936). But see *Securities Allied Corp.* v. *Commissioner* (2 Cir. 1938), 95 F. 2d 384, 20 AFTR 1111. (This case held that frequent Congressional reenactment had given to the regulation the force of law.)

With respect to short sales: Even dealers may not inventory them; assets only are inventoriable; liabilities are not.[32]

7. Amortization of Bond Premium

A dealer in securities is ordinarily not permitted to amortize any premium[33] paid on the purchase of a bond,[34] and any loss incurred on the sale of such bond is fully deductible against any income.[35] So far as investors and traders are concerned, the rules respecting amortization of a bond premium vary according to the status of the bond involved, as summarized in the table[36] on page 1036.

Under the 1939 Code, investor or trader could amortize bond premiums even though the first call date was only a short period from the date of acquisition. It was possible for taxpayers to buy bonds in order to get the amortization deduction and thus write off part of their costs over a short period where it was known that there was little risk of an early call as a practical matter. Under Section 171 of the 1954 Law, on fully taxable bonds, any call date within three years of the issuance date of the bonds is ignored in computing amortization with respect to bonds issued after January 22, 1951 and acquired by the taxpayer after January 27, 1954. However, under Section 171(c)(2) if such a wholly taxable bond is called before maturity the holder is allowed a deduction for the amortized bonds premium in the year in which the bond is called.

Any loss incurred by a trader or investor on the sale or exchange of the above-mentioned bonds is a capital loss. In addition, this loss is reduced by the adjustment to the basis resulting from the amortization of the bond premium.

Section 203 of the Revenue Act of 1950 changed the status of tax exempt bonds held by dealers in securities.[37] With respect to state and municipal bonds that have

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[32] S. 1179, 1919-1 C.B. 60.

[33] Bond premium on any bond to which IRC § 171 applies is the difference between the adjusted basis and the amount payable on maturity or earlier call date. The amortizable amount is that part of the bond premium attributable to the taxable year. But see the limitations in Section 171(b) IRC referred to in the text.

[34] IRC § 171 provides for the amortization of bond premium by the owner of bonds. Subdivision (d) thereof specifically excludes from the definition of "bond" for the purposes of IRC § 171 any obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Reg. 118, § 39.125-1 stated with reference to the citation above that "since bonds owned by dealers in securities are excluded from the foregoing definition, Sec. 171 has no application to such dealers." Present Section 171 is derived from former Section 125 of the 1939 Code.

[35] See discussion in Section 5.

[36] IRC § 171 and Reg. 118, § 39.125-1.

[37] IRC § 75.

Wholly Tax-exempt Bonds	Fully Taxable Bonds	Partially Tax-exempt Bonds
An adjustment to the basis only	(1) A deduction (2) An adjustment to the basis	(1) A deduction (2) An adjustment to the basis (3) A reduction of the credit under Sec. 35 and 242
Mandatory for investors and traders	Elective for investors and traders. (But see Section 171(b) limitation referred to the text.)	Mandatory for corporations and elective for other investors and traders

been held more than thirty days and that have a maturity or call date of not more than five years from the date of acquisition by the dealer, the premium paid must be amortized. Where dealers inventory their bonds at cost, such amortization reduces the basis so as to eliminate the loss that would otherwise be realized in the year of sale of the bond. Dealers who inventory their bonds at market prices use the amount of amortization for any year to reduce the cost of sales for that year.[38]

8. Commissions

The tax treatment of commissions paid on the purchase of securities is the same for dealers, investors and traders. In each case these commissions are capital items —a part of the cost price of the securities.[39] Commissions paid on the sale of securities are similarly treated except in the case of dealers, who are permitted to deduct such commissions as ordinary and necessary business expenses.[40] In making this distinction, the Supreme Court pointed out that practical considerations of accounting convenience made it as difficult for dealers to set commissions off against the proceeds of individual sales as it would be for a merchant of other wares to treat his selling expenses only as a series of subtractions from the selling price realized on particular items of his stock.[41]

9. Stamp Taxes

The Code[42] provides that Federal stamp taxes on the sale of securities are not deductible as taxes under Section 164(b), but may be deducted under Section 162 relating to ordinary and necessary business expenses. The Service has taken the position that only dealers may take such a deduction and that investors and traders must offset amounts paid as Federal stamp taxes against the selling price of securities.[43] This position that the same item is expense for the dealer and capital for the trader seems logically indefensible. Even though the trader does not sell to customers, he is in business as much as is the dealer. The Bureau has recently abandoned a similar contradictory position with respect to the deductibility of short dividends and premiums paid by a trader. It would seem proper for them to act similarly as far as Federal stamp taxes are concerned.[44]

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[38] IRC § 75.

[39] *Helvering* v. *Winmill*, 305 U.S. 79 (1938); Reg. 118, § 39.24(a)-2.

[40] *Spreckels* v. *Commissioner*, 315 U.S. 626, 28 AFTR 1010 (1942); Reg. 118, § 39.24(a)-2, see also *Don A. Davis*, 4 T.C. 329 (1944), affirmed (8 Cir. 1945) 151 F. 2d 441, 34 AFTR 335, which held that selling commissions were not deductible by investors as nonbusiness expenses under § 212 on the grounds that Congress, in enacting that Section, did not intend to permit an individual to deduct from gross income as ordinary and necessary expenses thereunder the selling costs that would not be deductible as business expenses under § 162. See *James M. Straub*, 13 T.C. 288 (1949).

[41] *Spreckels* v. *Commissioner*, footnote 41, above; G.C.M. 15,430 (1935), XIV-2 C.B. 59.

[42] IRC § 164(b). This section was added by § 111 of the Revenue Act of 1943 and is applicable to taxable years beginning after December 31, 1943. Prior to January 1, 1944, Federal stamp taxes were deductible as "taxes" by dealers, traders and investors. G.C.M. 18,245, 1937-1 C.B. 70.

10. Short Dividends and Premiums[45]

Short dividends and premiums on stock sold short are deductible by dealers as ordinary and necessary business expenses.[46] In the case of a trader in securities, a conflict has existed as to whether such payments were capital items,[47] or ordinary and necessary business expenses.[48] This conflict now would seem to be resolved in favor of such items' being treated as an ordinary and necessary business expense by the acquiescence of the Commissioner[49] in the view of the Tax Court that short dividend and premium payments are "not incurred as an incident either to the acquisition or the sale of the property involved, but are more in the nature of carrying charges incurred during the progress of the deal." [50]

Logically, short dividend and premium payments also would seem to be an expense item for an individual investor and to be deductible under Section 212, which relates to investor's expenses. Although certain cases[51] have held that these payments were capital items for investors, these cases were decided prior to the enactment of Section 212. Moreover, the abandonment by the Commissioner of the theory that short dividend and premium payments are capital items in the case of a trader apparently indicates a similar treatment as to an individual investor.[52] The same may not be true, however, with respect to a corporate dealer

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[43] I.T. 3806, 1946-2 C.B. 41.

[44] See § 10. Compare the tax treatment of commissions on the sale of securities in § 8.

[45] A short dividend is an amount equivalent to dividends paid on account of stock borrowed to make short sales. A short premium is an amount paid for the loan of securities. See *Provost* v. *U.S.*, 269 U.S. 443, 450-52, 5 AFTR 5681 (1926), explaining the mechanics of the short sale, and *F. A. Wilson* (1946), par. 46,177 Prentice-Hall Memorandum T.C., affirmed (9 Cir. 1947), 163 F. 2d 680, 36 AFTR 78, cert. den. 332 U.S. 842 (1947).

[46] See footnote 49, below.

[47] *Commissioner* v. *Levis' Estate* (2 Cir. 1942), 127 F. 2d 796, 29 AFTR 413, cert. den. 317 U.S. 645; *Helvering* v. *Wilmington Trust Co.* (3 Cir. 1941), 124 F. 2d 156, 28 AFTR 624. This was reversed on other grounds, 316 U.S. 164, 28 AFTR 1467 (1942).

[48] *Dart* v. *Commissioner* (4 Cir. 1935), 74 F. 2d 845, 14 AFTR 929; *F. A. Wilson*, footnote 45, above; *Norbert H. Wiesler*, 6 T.C. 1148 (1946), affirmed (6 Cir. 1947), 161 F. 2d 997, 35 AFTR 1407, cert. den. 332 U.S. 842 (1947) (A. 1948-1 C.B. 3); *W. Hinckle Smith*, 44 B.T.A. 104 (1941) (A. 1948-1 C.B. 3).

[49] *Norbert H. Wiesler* and *W. Hinckle Smith*, footnote 48, above.

[50] *Norbert H. Wiesler*, footnote 48, above.

[51] *Gladys G. Terbell*, 29 B.T.A. 44 (1933), affirmed (2 Cir. 1934), 71 F. 2d 1017, 14 AFTR 374; *Henry F. DuPont*, 38 B.T.A. 1317 (1938), affirmed (3 Cir. 1940), 110 F. 2d 641, 24 AFTR 548, cert. den. 311 U.S. 657 (1940). Compare, *Pierre S. DuPont*, 37 B.T.A. 1198, affirmed (3 Cir. 1941) 118 F. 2d 544, 26 AFTR 746, cert. den. 314 U.S. 623 (1941); *Deputy* v. *DuPont*, 308 U.S. 488, 23 AFTR 808 (1940).

[52] The Treasury has now accepted this view. I.T. 3989, 1950-1 I.R.B. p. 2, allows investors deductions under IRC § 212 for short dividends and premium payments in connection with short sales.

Federal Tax Consequences Chart of Classification as a Dealer, Investor, or Trader in Securities

	Dealer	*Investor*	*Trader*
Amortization of bond premium....	Not amortizable except for premium on certain tax exempt bonds which must be amortized	(1) Must amortize premium on wholly tax exempt Bonds (2) Elective on fully taxable Bonds (3) On partially tax exempt Bonds mandatory for corporations and elective for other taxpayers	(Same as investor)
Gain and loss on sale of securities..	(1) Gains and losses ordinary income and deductions (2) Profits not personal holding company income or foreign personal holding company income (3) Net losses includible without limitation in net or rating loss carry-back and -forward	(1) Gains and losses are capital gains and losses (2) Profits are personal holding company income and foreign personal holding company income (3) A net capital loss is not deductible in any amount against ordinary income in case of a corporation and in case of other than corporation only to extent of $1,000 or other net income whichever is smaller	(Same as investor)
Commissions			
(1) On Purchase of Securities....	(1) Are part of the cost	(1) (Same as for dealer)	(1) (Same as dealer)
(2) On Sale of Securities........	(2) Deductible as ordinary and necessary business expense	(2) Offset against the selling price	(2) (Same as investor)
Inventory securities............	May inventory securities	May not inventory securities	(Same as investor)
Stamp taxes....................	May be deducted as ordinary and necessary business expenses	Offset from selling price	(Same as investor)
Short dividends and premiums.....	Deductible as ordinary and necessary business expenses	See discussion in Section 10	(Same as dealer)
Wash sale losses................	Deductible	Not deductible	Deductible by an individual trader but not by a corporate trader

who also acts as an investor, and in that capacity sells short. If the business of the corporation is considered to be solely that of acting as a dealer in securities, then the payments would not seem deductible under Section 162(a) as an ordinary and necessary business expense nor under Section 212. This Section relates to investor's expenses, the application of which is in terms limited to individual taxpayers.

11. Wash Sale Losses

Dealers, whether individual or corporate, may deduct wash sale losses. However, only individual traders may deduct these losses. Investors may not deduct them under any circumstances.[53]

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[53] IRC § 1091 prohibits the deduction of a loss from a wash sale by an individual under § 165(c)(2) or by a corporation under § 165(a) unless the corporation is a dealer in stocks or securities. See also Reg. 118, § 39.118-1; I.T. 2523, 1930-1 C.B. 145; Compare, *Sol H. Morris*, 38 B.T.A. 265 (1938) (A) Allowing loss in case of individual trader with *Richard Coulter*, 32 B.T.A. 617 (1935), disallowing loss in case of individual investor.

Part VIII

MAKING PARTICULAR TYPES OF SALES OR PURCHASES

64

Selling an Entire Business

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It should seem obvious in most transactions involving the sale of an entire business that the motivating factors of the parties are not necessarily based primarily on the tax considerations.

There are those transactions where either the buyer or the seller is in the "cat bird" seat, whereby such party can usually control the negotiations to his best advantage regardless of the tax consequence to the other party. From the standpoint of the seller, this situation could arise in the case of a very profitable business or one in demand as has happened during the post-war period in those businesses for which there were buyers willing to offer what seemed in some instances to be exorbitant prices for the business. Insofar as the seller is concerned, the shoe would be on the other foot in a buyer's market, or where the seller is desirous of making an immediate sale or must otherwise sell due to the health, death, family or financial troubles of the owner, or the need or desire to retire from the business due to pressure of other matters.

Thus, where the parties want to buy or sell badly enough, the tax consideration on one side or the other, though important, may only be secondary, even though the transaction may work out to the best possible tax advantage of one party as against the other. That is not to say that one contemplating the sale of a business should disregard the effect of taxes on the transaction. On the contrary, it should be considered when the first thought of getting out of the business through sale or otherwise comes to mind. It would be wise to consider the problem from time to time in anticipation of the ever present possibility that the business may ultimately be sold should a prospective buyer ever happen along with the right offer.

The problem of sale of an entire business is an aggregation of many other problems. It is not possible to set out all the ramifications of all such transactions as to all the ultimate possibilities and consequences that may be lurking in the unforeseeable future. By giving effect to all possible factors that are evident from the business at hand, it would seem that no one could be left with the impression that the only or controlling factor was the tax consequence. In the absence of a set factual situation, some questions may be raised which are not discussed here. It is important, therefore, that each set of circumstances be considered carefully.

In tax parlance, it has been stated that the fruit (income) is taxable to the owner of the tree (property). Going beyond that, a transfer of an entire business can be compared with the transplanting of the tree, since in both instances it means getting to the root of the problem and a certain amount of pick and shovel work (details and thorough investigation) depending upon the size of the business, or the tree—such considerations just cannot be overlooked.

1. Points to Consider

Although the seller is primarily concerned with those factors relating to the sale and disposition of the business, he must also be able to answer the inquiries of a prospective purchaser, including those relating to the tax advantages or disadvantages. In any event, the seller must also be made aware of the tax aspects from the viewpoint of the buyer, so as to overcome some claimed tax consequence which may be made by the buyer to gain an advantage in negotiation, price, manner of sale, or otherwise. This may also make possible the offer of some advantage to the buyer without disadvantage to the seller.

A fact that cannot be overlooked is that tax economy must be considered an integral part of what a prudent businessman might commonly refer to as plain, ordinary, good business economy, since important decisions can rarely be made in these times without considering the tax consequence. This raises the questions of what the seller desires or expects to realize after consideration of taxes, and of how this might best be achieved because, apart from the selling price itself, taxes, probably more than any other factor, will affect the net proceeds to the seller. Whether or not larger proceeds may be obtained by parcelling assets out to several purchasers than by selling the business as a unit must be investigated. Where all the possibilities are considered, there may be a substantial area of mutual satisfaction between the seller and the buyer, which may afford a better price to the seller without the loss of any tax advantage to the buyer. Thus, calculations and investigations must be made of the tax consequence of various methods of sale open to the seller. Consideration of the question of whether it would be economically sound, tax-wise and otherwise, for the seller to proceed in the manner planned, may leave the way open for still further suggestions. A form of "check sheet" should be prepared to be sure everything required has been covered.

The seller should be ready to compromise with the purchaser on adequate covenants of indemnification against probable, as well as contingent, liabilities. In the case of a corporation, there would usually be the contingency for income taxes of prior years, where the statute of limitations has not run. Of course, adequate provision would have to be made for current year taxes and for undisclosed liabilities, possibly including a provision for surtax on improper accumulation of surplus, where the circumstances so warrant.

Some form of escrow fund will be required where, upon acquisition of the stock, the purchaser dissolves the corporation and then becomes liable as the transferee-in-liquidation. 1954 IRC § 6901(c)(1) (1939 IRC § 311(b)(1)) provides that the limitation period for assessment against the transferee extends for one year beyond the expiration of the limitation period for assessment against the original taxpayer. Although the limitation period for the final return of the dissolved corporation can be reduced to eighteen months by requesting prompt assessment under 1954 IRC

§ 6501(d) (1939 IRC § 275(b)), the provisions of Section 6901(c)(1) extend that period an additional year.[1]

Where a parent corporation, which may find it advantageous to file a consolidated return, sells control of a subsidiary corporation which was a member of the affiliated group, provision should be made in the contract binding the corporation sold to furnish such authorization and consents as may be desired by the parent corporation, to insure inclusion in the consolidated return of the income or loss of the former subsidiary for the taxable year to the date of sale.

Problems relating to minority stockholders' approval, in the event of the need for a quick sale of assets, must also be investigated and solved. The question of whether the sale of the assets should properly be attributed to a corporation or its stockholders, in connection with the liquidation of the corporation, is of decisive importance to the seller. Because a corporation is not deemed to have realized any gain by distribution of its assets in kind to its stockholders, the tendency would be to have the liquidating corporation distribute the assets in kind to the stockholders, who could then dispose of them, rather than to have the tax on the gain attributable to the corporation, had *it* made the sale. Such procedure, where recognized to be a sale by the stockholders, will result in a single tax on the liquidation gain to the stockholders measured by the fair market value of the assets so received, compared with the cost basis for the stock so surrendered, rather than a double tax—once on the corporation's gain from the sale of its assets and thereafter on the gain by the stockholders receiving the proceeds on liquidation. While the enactment of Section 337 of the 1954 Code has modified the above rule under certain limited circumstances, the general proposition that a sale by one person cannot be transferred for tax purposes into a sale by another by using the latter as a conduit through which to pass title, is still a valid statement of taxation principle.

Among the liabilities (known or contingent) of concern to a prospective buyer, with which the seller will have to cope, might be pensions, vacation pay, unpaid or disputed bills, outstanding or impending legal suits, violation of past price or wage regulations, violation of wage hour laws, and pending tax cases. Concern with respect to these matters on the part of the buyer may require the seller to give some degree of protection such as placing part of the purchase price in escrow for some specified period or until the designated contingencies are settled.

Among the problems of taxes in general will be those relating to the various other taxes, such as social security, excise taxes, state income taxes, unemployment taxes, and property taxes. Benefits to be derived where transfers of state unemployment insurance reserves and merit ratings are possible, may be of sufficient importance to offset some factor considered to be a disadvantage to the seller.

The seller of stock will have to consider carefully any arrangement offered whereby he is to receive, over a period of time, a fee for management services, because generally it will be classified as compensation taxable as ordinary income. Such an arrangement may be attractive to the purchaser because such payments, if reasonable in amount, would be fully deductible by the corporation in determining operating income of the business. On general principle, the seller should be wary of any schemes whereby the purchaser offers to pay the seller any difference between ordinary and capital gains rates, so that the purchaser may gain some tax advantage.

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[1] *Estate of Arthur T. Marix*, 15 T.C. 819 (1950); *J. B. Cage, et al.*, 15 T.C. 529 (1950).

In connection with the sale of stock of the corporation, or liquidation of the corporation to obtain the assets, consideration must be given to the likelihood of the corporation falling within the "collapsible corporation" category under 1954 IRC § 341 (1939 IRC § 117(m)). The Treasury Regulations 118, § 39.117(m)-1 relating to collapsible corporations may be a catch-all, and so must be reckoned with in the sale of any corporation that has inventories or which may otherwise be vulnerable.[2]

Techniques which the seller may pursue in the sale of an entire business are:

1. Business of a corporation.
    a. Sale of stock by stockholders.
    b. Sale of assets by the corporation.
    c. Sale of assets by distributees of liquidated corporation.
2. Business of a sole proprietor.
    a. Sale of the entire interest (equity).
    b. Sale of assets.
3. Business of a partnership.
    a. Sale of partnership interests.
    b. Sale of assets by partnership.
    c. Sale of assets by distributees of liquidated partnership.

Points of a more elaborate nature to consider are:

	Section
Sale of stock by stockholders	2
Sale of assets by the corporation	3
Sale of assets by the distributees of liquidated corporation	4
Sale of an entire business conducted by the individual	5
Sale of entire business conducted as a partnership	6
Good will and covenants	7
Allocations, valuations and basis in general	8
Consideration of losses	9
Formalities to be considered	10
Capital gains and non-capital gains	11
Methods of reporting income	12
Conclusion	13

2. Sale of Stock by Stockholders

From the seller's point of view, the sale of the stock of a corporation is the simplest and possibly the safest way of handling the sale. By selling the stock, the seller has capital gain if the adjusted cost basis is less than the selling price, and to the extent that the stock was held for more than six months prior to the sale, there will be a long-term capital gain. Thus, consideration must be given to the holding period of all the shareholdings since some stock may have been held less than the required period. Also, if a loss is to result, consideration must be given to how such loss is to be absorbed, due to restrictions applicable to a net capital loss,[3] and whether it might be better either to defer the sale or to proceed in some other way.

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[2] See comments re: "Ordinary Corporation" pages 432-433 of article on "Collapsible Corporations" by Lionel J. Freeman in *Proceedings of New York University Eleventh Annual Institute on Federal Taxation*, Matthew Bender and Company, 1953.

[3] 1954 IRC § 1211; 1939 IRC § 117(d).

The seller ordinarily should not permit any statement, in the agreement for the sale of the stock, that the purchase was being made solely for the purpose of acquiring the assets of the business, because this may later serve to overcome the contention that the seller was selling stock and not assets. However, for the benefit of the purchaser, the seller might keep in mind cases where no gain on liquidation resulted where the stock was purchased to acquire the assets.[4] The principle underlying these decisions has been adopted by statute in Section 334(b)(2) of the 1954 IRC.

The seller of the stock should be ready to make available to the buyer all information pertaining to the tax basis of assets, since the book value cannot always be relied upon as correctly reflecting the basis of the assets for tax purposes. Such information might include the revenue agent's reports relating to adjustments to basis due to capitalized deductions, changes in depreciation, and tax-free transfers or exchanges.

Certainly, a corporation which has had a bad tax background and pending tax cases concerning additional assessments, could be a bad risk for the future, regardless of suggested adjustment for such contingencies in the selling price. The seller of the stock of such corporation can usually expect greater resistance to his offer than may be the case under more ideal conditions.

Other factors detrimental to the seller of the stock of a corporation to be taken into account might be some of the following:

1. Limitation on officers compensation.
2. Unfavorable employment contracts.
3. Possible exposure to assessment of surtax on improper accumulation of surplus under Subchapter G, Part I 1954 IRC; (1939 IRC Sec. 102).
4. Bad customer relationship.
5. Bad employee relationship or labor trouble.
6. Problems relating to leases and lease assignments.
7. Accounting methods elected as to valuing inventories, computing depreciation, depletion, amortization, bad debts, fiscal year, and accrual basis or cash basis.
8. Pension plans that may be in effect.

In the past, the seller of the stock of a deficit corporation has realized a considerable benefit, particularly where the buyer could contribute a profitable business to such corporation so as to take advantage of the operating loss carryovers.[5] As indicated later in this chapter, under "Consideration of Losses," the provisions of the 1954 Code have largely dissipated this incident of benefit from future transactions.

There may be instances where the seller would want to sell off the stock on a gradual basis, leaving him with income over an extended period from dividends and salaries for services in an advisory capacity. In some instances it may be advisable to arrange for the sale on the installment basis, particularly where there is a lack of available cash for the payment of the tax. If not more than 30 per cent of the purchase price will be paid in the year of sale, the seller can elect to report the gain on the installment basis as provided by 1954 IRC § 453(b) (1939 IRC § 44(b)). The effect of the application of this section is that the seller will pay the tax on that portion of the gain determined for each installment in the year he receives it. Failure to make the proper election to report on the installment basis will result in the entire gain being taxable for the year of the sale, to the extent determined by the fair market value of the installment notes at the time of sale.

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[4] *H. B. Snively, Transferee,* 19 T.C. 850 (par. 19.102 P.-H. TC 1953) similar *Ashland Oil and Refining Co.* v. *Commissioner* (6 Cir. 1938), 99 F. 2d 588, 21 AFTR 1168 Certiorari denied 306 U.S. 661, reversing 32 B.T.A. 777 (Swiss Oil Corp.—1935); also where there was in substance the purchase of property, *The Koppers Coal Company,* 6 T.C. 1209 (1946); *Kimball-Diamond Milling Co.* (5 Cir. 1951), 187 F. 2d 718, 40 AFTR 328, certiorari denied 342 U.S. 877, 40 AFTR 1174 (1951), affirmed 14 T.C. 74 (1950).

[5] *Alprosa Watch Corp.,* 11 T.C. 240 (1948); *A.B. & Container Corp.,* 14 T.C. 842 (1950); *WAGE, Inc.,* 19 T.C. 249 (1952).

Where, in selling the stock, the seller agreed to accept a stipulated price over a designated period of time conditioned upon his retention of record ownership of the stock as security, those dividends paid to the seller and credited against the selling price of the stock pursuant to agreement were taxable to the purchaser (the real owner) and not the seller (record owner).[6] In any arrangement such as this the seller, since he is a nominee, should be sure to file information returns as to the actual owner of dividends paid, as is required of a record owner.[7]

The administrators of an estate which owned all the stock of a corporation, after several unsuccessful attempts to sell the stock, accepted an offer to sell part of the stock to other parties in contemplation of retirement by the corporation of the remaining unsold shares, in exchange for notes of the corporation. In this case,[8] the Commissioner was unsuccessful in his attempt to treat the retirement of the stock of the seller by the corporation as a taxable dividend to one of the purchasers.

In a somewhat similar situation the Court of Appeals for the Sixth Circuit in *Zenz* v. *Quinlivan*[9] also ruled in favor of the taxpayer. Here Mrs. Zenz owned all 108 shares of a corporation which had earnings and profits of some $48,000. She sold 47 shares to outsiders who took over control of the Board of Directors with her consent. A few weeks later, the corporation acquired her remaining 61 shares for an amount which approximated the amount of the corporation's earnings and profits. The Circuit Court held that since the intent of the taxpayer was to liquidate her holdings completely and to divest herself of all interest in the corporation, the distribution of the earnings and profits by the corporation in payment for her stock was not made at such time and in such manner as to make the distribution essentially equivalent to the distribution of a taxable dividend. The Internal Revenue Service has indicated that it will follow this decision, with the qualification that every case in which a stockholder sells part of his stock to new or existing stockholders and thereafter transfers the remainder to the corporation for redemption will be closely scrutinized to determine whether the selling stockholder "ceases to be interested in the affairs of the corporation" immediately after the redemption.[10]

Despite the fact that Section 302 of the 1954 Code contains some clarification of the status of stock redemptions, the retention of the broad and vague "essentially equivalent" [11] formula makes it clear that each factual situation should be very carefully appraised in view of the law and the cases cited serve as a warning to the seller to beware of favoring the buyer's wishes too much. It must also be kept in mind that situations may arise where the arrangement of sale insisted upon by the purchaser will warrant requesting indemnification covenants in favor of the seller in the contract.

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[6] *Estate of Arthur L. Hobson*, 17 T.C. 854 (1951).

[7] Reg. 111, § 29.147-8.

[8] *Ray Edenfield*, 19 T.C. 13 (par. 19.3 P.-H. TC 1952).

[9] 213 F. 2d 914 (1954) (par. 72,617 P.-H. Fed. 1954); reversing 106 F. Supp. 57 (D.C. N.D. Ohio W.D. 1952) (par. 72,531 P.-H. Fed. 1952).

[10] Rev. Rul. 54-458; IRB 1954-12 (par. 76,999.130 P.-H. Fed. 1954).

[11] Sec. 208 of Revenue Act of 1950 amending Sec. 115(g) IRC.

Of course, accumulated earnings and profits of the corporation will be a factor because of the buyer's resistance to acquiring, through the purchase of the stock, equity which will be taxable as ordinary dividends upon subsequent distribution in the event of continuance of the corporation by the purchaser. Any such objection would be logical, since the distributions of such equity under the circumstances would, in effect, be nothing more than a return of a part of the purchaser's investment but which, to the extent of earnings and profits of the corporation, would be taxable to the purchaser.

It would appear that it is no longer possible to sell the stock of one corporation to another controlled by the same interests at the capital gains rate. While Congress, in the Revenue Act of 1950, limited to ordinary income the gains on sales of a parent corporation's stock to its subsidiary by a stockholder, no such restriction was placed on gains made on sales of stock of one corporation by stockholders of the other corporation in the brother-sister type corporations at that time. However, under Section 304 of the 1954 Code a similar treatment is accorded purchases after June 21, 1954 from a controlling stockholder of stock in one corporation by a brother corporation.

Care must be taken in option arrangements. Where stock which was owned less than six months was transferred to an optionee under a loan-option agreement it was held to have resulted in a short term capital gain to the owner when the optionee immediately contracted for the sale of the stock notwithstanding the fact that the optionee did not exercise his option until a year later when the buyer paid him for the stock. The optionee was considered under all the facts of the case to be acting as a conduit and agent of the owner.[12]

While the case of *Irving R. Lewis*[13] deals with the sale of stock of 50 per cent interests to the owners of the other 50 per cent interests, it points up a factor to be reckoned with in the sale of an entire incorporated business. There, cancellation of accrued salaries due officers-stockholders of the corporation resulted in ordinary income to them upon the sale of their stock interest. The effect of such cancellation of the accrued liability was to increase the book value and sales value per share whereby the accrued salaries were deemed, in substance, to have been received by them as part of their selling price of the stock. The negotiations relative to the forgiveness of accrued salaries due were carried on contemporaneously with those regarding the sale of stock. The court considered that the evidence clearly showed that the purchasers would not have agreed to pay as much per share as they did had not the liability for payment of salaries been thus cancelled. The actual cancellation on the books was made only after complete compliance with all agreements and the agreed price had been received by the sellers.

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[12] *Deal, et al.* v. *Morrow* (par. 72,549 P.-H. Fed. 1952) 5 Cir.; reversing (D.C., N.D. Ala.) (par. 72,541 P.-H. Fed. 1951).

[13] (Par. 19.107 P.-H. TC 1953).

3. Sale of Assets by the Corporation

The stockholders may have specific reasons for desiring to retain their corporate charter, in which case they could do so only if they have the corporation sell its assets rather than for them to sell their stock. If the corporation is to sell its assets rather than distribute them in liquidation, then all negotiations and formalities should be conducted in the name of and on behalf of the corporation. There may be the tendency to overlook this because of the thinking in terms of "double tax detriment" rather than possible "double loss benefits."

Where the stockholders personally desire to postpone the capital gains tax that would result in the event of a gain on the sale of the stock or liquidation of the corporation, the corporation would sell the assets. Among some of the reasons why the stockholders may want to retain the corporation after the sale of the business assets would be:

1. Deferment of taxable gain on dissolution.
2. Investment in a business of a type other than that which was sold.
3. Possible benefit of operating losses by contributing a new and more profitable business.
4. To avoid capital losses on liquidation not likely to be absorbed due to limitation provisions.

In *Evansville Oil Corporation, Jack Coast, Liquidator*[14] the Commissioner contended that the loss on the sale of the assets of the corporation was a loss to the stockholders rather than the corporation. In view of the manner in which the transaction was handled, particularly by the purchasers, it was shown that at all times it was the understanding of the purchasers that they were buying the assets from the corporation. The Tax Court agreed with the taxpayer that it was the corporation that made the sale. The loss on the sale of its assets resulted in a net operating loss carry-back to the corporation. Aside from *Evansville Oil*, another case, in which it apparently was important to the seller that the buyers understood at all times with whom they were dealing, was *Howell Turpentine Company* v. *Commissioner*.[15]

The Supreme Court's decision in *Court Holding Co.*[16] held that the sale of assets by the stockholders was to be imputed to the corporation. In its decision in *Cumberland Public Service*,[17] dealing with the same issue, the Supreme Court held that a sale of the assets by the stockholders could not be imputed to the corporation, and in referring to *Court Holding Co.*, said:

> Our *Court Holding Co.* decision rested on findings of fact by the Tax Court that a sale had been made and gains realized by the taxpayer corporation. There the corporation had negotiated for the sale of its assets and had reached an oral agreement of sale. When the tax consequences of the corporate sale were belatedly recognized, the corpo-

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[14] (Par. 53,016 Prentice Hall Memorandum TC—1953).

[15] (5 Cir. 1947) 162 F. 2d 319, 35 AFTR 1459 reversing 6 T.C. 364 (1946).

[16] 2 T.C. 531 (1943), reversed (5 Cir. 1944) 143 F. 2d 823, 32 AFTR 1088, reversed 324 U.S. 331, 33 AFTR 593 (1945).

[17] 338 U.S. 451, 38 AFTR 978 (1950), affirming 113 Ct. Cl. 460, 83 F. Supp. 843, 37 AFTR 1333 (1949).

ration "called off" the sale at the last minute and distributed the physical properties in kind to the stockholders. They promptly conveyed these properties to the same persons who had negotiated with the corporation. The terms of purchase were substantially those of the previous oral agreement. One thousand dollars already paid to the corporation was applied as part payment of the purchase price. The Tax Court found that the corporation never really abandoned its sales negotiations, that it never did dissolve, and that the sole purpose of the so-called liquidation was to disguise a corporate sale through use of mere formalisms in order to avoid tax liability. The Circuit Court of Appeals took a different view of the evidence. In this court the government contended that whether a liquidation distribution was genuine or merely a sham was traditionally a question of fact. We agreed with this contention, and reinstated the Tax Court's findings and judgment.

In *Kaufman, et al.* v. *Commissioner*,[18] the corporation was held to have made the sale of the assets of the business where it was found that the chief executive officer (related to the stockholders but not himself a stockholder) initiated negotiations that were substantially cast into the form of an agreement for sale of the assets by the stockholders as individuals, all before any steps had been taken to liquidate and dissolve the corporation. It was considered that, in connection with liquidation of the corporation, the stockholders were mere conduits through which title to the property passed to the purchaser previously agreed upon. Under the circumstances, the court also took note of the fact that the stockholders involved were also directors and as such were under legal duty to deal with corporate property on behalf of the corporation and for its benefit, particularly where the rights of others (bondholders) were involved.

An interesting situation arose concerning the sale of the assets of a corporation upon the termination of a joint venture, consisting of two corporations which will be referred to as "L" and "A." By the terms of the termination agreement which resulted from disputes as to operations, "L" agreed to pay the stockholders of "A" for all the property, assets and rights of "A." In this case,[19] the Tax Court held that such payment by "L" was taxable to "A," having resulted from the sale of all of the assets of "A." The Second Circuit modified and remanded the case to the Tax Court so that Corporation "A" may offer evidence to show what part of the consideration should be allocated to the stockholder for her consent to terminate the part of Corporation "A" in the joint venture.

Superimposed upon this background of case law, the 1954 Code has further broadened the liberal rule of the *Cumberland* case. Section 337 thereof, recognizing that corporate assets could be distributed in kind to the stockholders without tax to the corporation, provides that the corporation may dispose by sale or exchange, within twelve months immediately following the adoption on or after June 22, 1954, of a plan of complete liquidation of its assets without recognition to it of gain or loss. All of the corporate assets, except those retained to meet obligations must, however, have been distributed by the end of the twelve month period. Inventories and installment obligations connected with their sale are included in this non-recognition rule only if substantially all of the inventory is sold in bulk to the same person. If the inventories are sold in the ordinary course of business, even though for the avowed purpose of liquidating, such sales cannot qualify for this treatment. If a corporation distributed all its assets in complete liquidation as indicated above either before January 1, 1955 or within twelve months after adoption of the liquidation plan, if the plan was adopted in 1954 and before June 22, 1954, *it might elect* to have this non-recognition rule apply to its liquidating sales and exchanges under Section 392 of the 1954 Code.

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[18] (3 Cir. 1949) 175 F. 2d 28, 38 AFTR 23, affirming 11 T.C. 483 (1948).

[19] *American Range Lines, Inc.* v. *Commissioner* (2 Cir. 1952), 200 F. 2d 844 (par. 72,736 P.-H. Fed. 1952) modifying 17 T.C. 764 (par. 17.88 P.H. TC 1951).

It would be well to keep in mind that where a corporation sustains a net capital loss for the taxable year and then dissolves, there is no benefit. This is so since such a loss may not be offset against income from operations, nor may it be carried back because the law[20] only provides for a capital loss *carry-over*. While 1954 IRC § 1231 (1939 IRC § 117(j)) grants the taxpayer the option of treating as a capital gain the net gain that results from combining gains and losses on the sales of real property and depreciable property used in the trade or business and *held for more than six months*, it does not require that where there is a net loss under such circumstances it must be treated as a capital loss. Thus, any such loss, not being a capital loss, would be applied against income from operations or added to the operating loss in determining the amount of any net operating loss carry-back. If a loss which can be beneficially absorbed by the corporation is the expected result of the sale of the assets of the corporation, then the corporation should make the sale.

To compute the expected result of losses in such cases, a determination would first have to be made as to which assets were capital assets and which were non-capital assets for tax purposes. Such a determination would depend upon the kind of trade or business in which the corporation was engaged, the nature of the subject matter of the sale, and further, would require that the business be comminuted into its fragments and these separately matched under a 1954 IRC § 1221 (1939 IRC § 117) definition. Problems concerning the deductibility of such losses by a corporation are evident from the findings and a comparison of *Max Torodor*[21] with *Evansville Oil Corporation, Jack Coast, Liquidator*.[22] Max Torodor was a transferee in liquidation of *Rogers Utilities, Inc.*, a dissolved corporation that had sold its business, which included the sale of accounts receivable at a loss. The Commissioner successfully contended that the loss was a capital loss rather than an ordinary loss as claimed by the taxpayer. Since the corporation had no offsetting capital gains to which to apply the capital loss and had been dissolved, the loss deduction otherwise allowable as a carryover was completely lost to the corporation. *Evansville Oil*[23] (a corporation) involved the sale of depreciable property used in the trade or business where the loss as an ordinary loss was allowable as a carryback as part of the net operating loss, and so differs from the loss on the sale of accounts receivable which is a capital loss that can only be carried over and applied against capital gains of the corporation.

Though the *Torodor* case is illustrative of the point under discussion, it should be noted that under Section 1221 of the 1954 IRC receivables acquired in the ordinary course of business in return for services rendered or sales of a taxpayer's stock in trade are now classed as non-capital assets.

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[20] 1954 IRC § 1211(a); 1939 IRC § 117(d)(1) and 117(e)(1).

[21] 19 T.C. 530 (par. 19.68 P.-H. TC 1953), following *Graham Mill & Elevator Co.* v. *Commissioner* (5 Cir. 1945), 152 F. 2d 564, 34 AFTR 613, affirming (D.C., N.D. Tex. 1945) 34 AFTR 1644.

[22] Footnote 14, above.

[23] *Ibid.*

4. Sale of Assets by Distributees of Liquidated Corporation

All the stockholder who obtains the corporate assets in liquidation and then sells them is trying to do is to reach the same tax result that would follow had he sold his stock. In either case, the stockholder is making a final disposition of the investment, so one might ask why there should be any attempt to treat the transaction as if it had taken the more costly route of double taxation. Even if the liquidation of a corporation followed by the sale of the assets by the distributee stockholders may be looked upon as a form of tax avoidance, it hardly falls into the class of a "loophole" or "tax-scheme" since Congress has been made aware of this situation through the language of the Supreme Court in *Cumberland Public Service*,[24] and within the limitations set forth in Section 337 of the 1954 Code, the legislators have specifically bestowed their approval upon the nature of the transaction. Thereunder, if the corporation adopts a plan of complete liquidation conforming to the statutory requirements and so elects, liquidation sales and exchanges will not result in any recognized gains or losses to the corporation.

A long standing regulation[25] provides that a corporation does not realize gain or loss from the distribution of its property in kind in liquidation. It is thus recognized that a corporation realizes no gain from the distribution in kind upon its dissolution on the ground that the corporation neither made a sale nor discharged an obligation. 1954 IRC § 331(a) (1939 IRC § 115(c)) and related regulations,[26] provide as to distributions in liquidation, that amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

Following *Cumberland Public Service Co.*,[27] where on the facts it was held that the sale of assets by the distributee stockholders could not be imputed to the corporation, the Court of Appeals for the Eighth Circuit reversed the District Court in *St. Louis Union Trust Company, Executor* (Herman J. Sternberg Estate) v. *Finnegan.*[28] In this case, the Court of Appeals held that the corporation was not taxable on the gain from the sale of assets where the executor of the estate of the sole stockholder, after having received the assets in a genuine liquidation, had negotiated directly with the buyer.

Presumably, a "genuine liquidation" is one where the corporation has completely distributed its assets in liquidation, discharged its liabilities or otherwise provided for their discharge, wound up all corporate affairs generally, is legally dissolved in the state of its incorporation, and has otherwise conformed with all required formalities.

In reference to the discussion of evidence which supported the findings of fact in *Court Holding Co.*,[29] the Supreme Court, in *Cumberland Public Service*,[30] had this to say:

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[24] Footnote 17, above.
[25] Reg. 111, § 29.22(a)-20.
[26] Reg. 111, § 29.115-5.
[27] Footnote 17, above.
[28] (8 Cir. 1952) 197 F. 2d 565 (par. 72,527 P.-H. Fed. 1952) reversing 100 F. Supp. 1020 (D.C., E.D. Mo. 1951).
[29] Footnote 16, above.
[30] Footnote 17, above.

> This language does not mean that a corporation can be taxed even when the sale has been made by its stockholders following a genuine liquidation and dissolution. While the distinction between sales by a corporation as compared with distribution in kind followed by shareholders' sales may be particularly shadowy and artificial when the corporation is closely held, Congress has chosen to recognize such a distinction for tax purposes. The corporate tax is thus aimed primarily at the profits of a going concern. This is true despite the fact that gains realized from corporate sales are taxed, perhaps to prevent tax evasion, even where the cash proceeds are at once distributed in liquidation. But Congress has imposed no tax on liquidating distributions or on dissolution, whatever may be the motive for such liquidation. Consequently, a corporation may liquidate or dissolve without subjecting itself to the corporate gains tax, even though a primary motive is to avoid the burden of corporate taxation.

It was further stated:

> The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or sham, sales of physical properties by shareholders following a genuine liquidation in distribution cannot be attributed to the corporation for tax purposes. The oddities in tax consequences that emerge from the tax provisions here controlling appear to be inherent in the present tax pattern. For a corporation is taxed if it sells all its physical properties and distributes the cash proceeds as liquidating dividends, yet it is not taxed if that property is distributed in kind and is then sold by the shareholders. In both instances the interest of the shareholders in the business has been transferred to the purchaser. Again, if these stockholders had succeeded in their original effort to sell all their stock, their interest would have been transferred to the purchaser just as effectively. Yet on such a transaction the corporation would have realized no taxable gain. Congress having determined that different tax consequences shall flow from different methods by which the shareholders of a closely held corporation may dispose of corporate property, we accept its mandate. It is for the trial court upon consideration of an entire transaction to determine the factual category in which a particular transaction belongs.

In *Michael J. Shagan, et al., Transferees,*[31] the Commissioner argued that the stockholders of the corporation were merely a conduit for a sale by the corporation; that the corporation negotiated the sale and made the sale; and that the profit realized is, therefore, taxable to the corporation. The alleged critical fact which the Commissioner contended as supporting his determination was said to be that the buyers for the property were on hand prior to the adoption of the resolution to dissolve the corporation. On the facts, the court, in finding for the taxpayer, stated that the evidence clearly showed that the corporation did not offer its property for sale; it did not invite offers from any broker or prospective buyer; it did not authorize any of its officers or directors to consider or negotiate a sale of its only asset (an office building). The stockholders, after having unsuccessfully carried on negotiations to sell their stock, then decided to liquidate and take the property in return for the stock. The fact that there was delay in the issuance of a formal certificate of dissolution by the State of New York beyond the date of distribution to stockholders was considered by the court as "not related to the conveyance of the property in an exchange for stock in the liquidation of the corporation." The taxpayer here relied on other cases aside from *Cumberland Public Service Co.*[32]

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[31] Par. 52,233 Prentice Hall Memorandum T.C. (1952).

[32] Footnote 17, above; *Amos L. Beaty & Co., Inc.*, 14 T.C. 52 (1950); *Doyle Hosiery Corporation*, 17 T.C. 641 (par. 17.70 P.-H. TC 1951); *Howell Turpentine Company*, Footnote 15, above.

It is clear from the foregoing that prior to the passage of the 1954 Code the tax consequences arising from sales made in the course of liquidations depended primarily upon the formal manner in which the transactions were arranged. The underlying intention of Congress in enacting Section 337 of the 1954 Code was to provide a definitive rule which would dispel the aura of uncertainty which has in the past surrounded these transactions.

5. Sale of an Entire Business Conducted by the Individual

Perhaps the leading case regarding the treatment to be accorded a gain or loss from the sale of a sole proprietorship business is that of *Williams* v. *McGowan.*[33] There, the Court of Appeals held that, tax-wise, a sole proprietor cannot sell a "business," but rather that what was sold were the underlying assets. Based on that principle, the sale by an individual of his sole proprietorship "interest" would be considered to be the sale of the individual assets devoted to that business, since his "interest" in the business is not that of a single asset, nor does such "interest" constitute a capital asset such as that of an interest in a partnership or stock of a corporation. The extent of the capital gain or loss and the ordinary gain or loss on such sale would be determined according to the character of the particular assets of the business.

While there has been some willingness to accept this decision as correct and final, it must be remembered that it was the Commissioner who was contending that the sale of the business as a whole constituted the sale of a capital asset. Williams had suffered a net loss on the sale of his hardware business and had treated it as an ordinary loss, and had to go to the Circuit Court before being sustained. Obviously, the Commissioner's action was to restrict the amount of allowable loss under the capital loss provisions.

What effect the decision of the Ninth Circuit in the *Hatch* case,[34] which involved the sale of the entire business of a partnership, will have in future cases involving the sale of the entire business of a sole proprietor remains to be seen, but it could be a step nearer to recognition of the "entity" theory as regards the gain or loss on the sale of an entire unincorporated enterprise. Rather than speculate, it should be determined beforehand what the effect would be under the "collapsible corporation" rule if a sole proprietor in order ultimately to circumvent *Williams* v. *McGowan*[35] incorporated his business with the thought in mind of selling the stock prior to the expiration of the three year period as provided in 1954 IRC § 341(b)(3) (1939 IRC § 117(m)(3)(c)).

A similar determination would have to be made under Section 751 of the 1954 Code, where consideration is given to converting a sole proprietorship to a partnership so that the "ownership interest" would be a capital asset upon the event of a future sale. In addition, should such a conversion be feasible, it is important to watch that the "holding period," in determining whether the capital gain or loss would be long-term or short-term, would be likely to differ from that applicable under 1954 IRC § 1223 (1939 IRC § 117(h)) since the Courts have held with regard to a "partnership interest" that the "holding period" is the period during which the seller was a partner.[36]

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[33] (2 Cir. 1945) 157 F. 2d 570, 34 AFTR 615, reversing 58 F. Supp. 692 (D.C., W.D., N.Y. 1944), 33 AFTR 790.

[34] *Estate of Herbert B. Hatch* v. *Commissioner* (9 Cir. 1952), 198 F. 2d 26 (par. 72,529 P.-H. Fed. 1952), reversing 14 T.C. 251 (1950).

[35] Footnote 33, above.

6. Sale of Entire Business Conducted as a Partnership

In G.C.M. 26379,[37] it has been conceded that a "partnership interest" is a capital asset. An exception to this is the extent to which installment obligations are involved because, in *Rhett W. Woody,*[38] the sale of a partnership interest including the share of unrealized gain on unpaid customer installment obligations was reported as the sale of a capital asset. The Tax Court held that to the extent attributable to installment obligations, Woody realized ordinary income under the provisions of Section 44(d) of the 1939 Code (1954 IRC § 453(d)). The partnership had been reporting income on the installment basis. Another exception would be that earnings not previously taxed to the partners, such as current year earnings, would be ordinary income rather than capital gain. In *Arnold F. Meyer, Jr.* v. *Commissioner,*[39] the court held that the proceeds from the sale of partnership interests were taxable as ordinary income to the extent representing the selling partners' current year distributive share of partnership earnings not previously taxed, following *Le Sage, et al.* v. *Commissioner.*[40] There were similar findings in *Hamilton A. Gray,*[41] although Gray sustained a long-term capital loss on the sale of his interest.

The advantages of selling "partnership interests" must be weighed with those that would result from the sale of the assets of the business, but first it must be determined whether the sale of assets should be made by the partnership or individually by the partners after a distribution in kind to the partners in dissolution or otherwise. Distributions in kind of partnership assets may present problems of allocation considered in G.C.M. 20251.[42] Where the entire partnership business is sold, the question arises whether the partners sold their interests as a capital asset or whether the partnership sold its assets, requiring that the sale be comminuted into its fragments and these separately matched under the 1954 IRC, Subchapter P (1939 IRC § 117) definition.

In *Estate of Herbert B. Hatch,*[43] the Court of Appeals (9 Cir.), in reversing the decision of the Tax Court as being clearly erroneous, held that the sale of the partnership as a going business was a sale by all the partners of their respective "partnership interests" through which they realized a capital gain.

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[36] *Dudley T. Humphrey,* 32 B.T.A. 280 (1935); *Ellen Fuller,* par. 42,562 Prentice-Hall Memorandum B.T.A. (1942); *Allan S. Lehman* (2 Cir. 1948), 165 F. 2d 383, 36 AFTR 545 affirming 7 T.C. 1088 (1946).

[37] 1950-1 C.B. 58.

[38] *Rhett W. Woody,* 19 T.C. 350 (par. 19.46 P.-H. TC 1952); similar is *Estate of Meyer Goldberg* v. *Commissioner* (2 Cir. 1951), 189 F. 2d 634, 40 AFTR 761, affirming 15 T.C. 10 (1950).

[39] (D.C., E.D. Wis. 1950) (par. 72,632 P.-H. Fed. 1952).

[40] (5 Cir. 1949) 173 F. 2d 836, 37 AFTR 1233, modifying T.C. Memo. (par. 47,318 Prentice-Hall Memorandum TC-1947)—to the same effect is *Louis Karsch,* 8 T.C. 1327 (1947).

[41] (Par. 52,002 Prentice-Hall Memorandum TC-1952).

[42] 1938-2 C.B. 169.

[43] Footnote 34, above. Another case which resulted in treating the simultaneous sale of all the partners of their partnership interests as the sale of capital assets was *L. B. Davis* v. *U.S.,* (D.C., W.D. Tenn., 1949) (par. 72,396 P.-H. Fed. 1950).

Before getting into transactions that will result in the dissolution of the partnership, the effect on individual taxes of partners where two taxable years of the partnership end during a single taxable year of the partners must be considered.

Where a partner sells his interest in the partnership the holding period runs from the date of the original investment and not from the date or dates of acquisition by the partnership of specific assets.[44]

The determination of the best way of selling a partnership business will be affected by many variables among some of which will be:

1. Whether the greatest profit will result from capital assets or non-capital assets.
2. Personal income of the partners in the year of sale.
3. The taxable year of the partnership and each of the partners.
4. Tax basis of assets *v.* book value as to ultimate gain or loss.
5. Holding period of assets to be sold *v.* partnership interests.
6. Determination of tax basis cost of partnership interests, as for example, where there may be a difference between a partner's cost of such interest and the book equity where the "interest" was acquired from another.

7. Good-will and Covenants

In the sale of an entire business, whether a corporation, partnership, or sole proprietorship, the question of good-will arises. Even though good-will may not be shown on the books, the Commissioner of Internal Revenue will almost always try to place a value on it. All this presents another problem related to the sale of a business. Generally speaking, there would probably be little or no good-will where the income was derived largely from the personal services of the owners, or where the good-will attached to the manufacturers and not to the franchised distributor —(*S. Leigh Savidge,* par. 45,180 Prentice-Hall Memo. T.C. (1945); *Floyd D. Akers,* 6 T.C. 693 (1946)). On the other hand, it may be found that a considerable amount of good-will may exist where the earnings were not derived chiefly from personal services, the business has a long and successful history, and value can be attributed to the name. In the case of a corporation, the presence of a substantial amount of good-will may make the tax cost of dissolving it prohibitive. Section 29.22(a)-10 of Regulation 111, concerning the sale of good-will, says that: ". . . It is immaterial that good-will may never have been carried on the books as an asset, but the burden of proof is on the taxpayer to establish the cost or the basis of the good-will sold." Some interesting comments concerning the determination of good-will may be found in the *Estate of Henry A. Maddock.*[45]

In *Ethyl M. Cox, et al.,*[46] tangible assets were sold by oral contract for book value, and later $50,000 was received under terms of a written contract for the sale of the business that contained a non-competitive clause but did not mention good-will. All of the $50,000 had been treated by the taxpayer as having been received for the sale of good-will, taxable as capital gain, and the court sustained that view. The interest of the purchaser and the seller are at conflict here, since amounts received for a non-competitive covenant are taxed as ordinary income to the seller[47] and may be amortizable to the purchaser,[48] whereas amounts received for good-will are considered to be received from the sale of a capital asset and, of course, may not be amortized by the purchaser.

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[44] Footnote 41, above.

[45] 16 T.C. 324 (1951).

[46] 17 T.C. 1287 (par. 17,155 P.-H. TC 1952).

The seller has to be careful not to place himself at too much a disadvantage so as to give the buyer an advantage. In *Clarence Clark Hamlin Trust,*[49] it seems that the seller was persuaded to agree to an inclusion in the contract, for the sale of all the stock of a corporation, to the effect that 75 per cent of the selling price was for the stock and 25 per cent for a covenant not to compete. The Tax Court upheld the Commissioner's contention that, to the extent the proceeds applied to the covenant not to compete, it was ordinary income rather than capital gain, following *Rodney B. Horton,*[50] in which the court said:

> It is well settled that if, in an agreement of the kind which we have here, the covenant not to compete can be segregated in order to be assured that a separate item has actually been dealt with, then so much as is paid for the covenant not to compete is ordinary income and not income from the sale of a capital asset. *Estate of Mildred K. Hyde* 42 B.T.A. 738. On the other hand, where the covenant not to compete accompanies the transfer of good-will in the sale of a going concern and it is apparent that the covenant not to compete has the function primarily of assuring to the purchaser the beneficial enjoyment of the good-will which has been acquired, the covenant is regarded as non-severable and as being in effect a contributing element of the assets transferred. *Toledo Newspaper Co.,* 2 T.C. 794; *Toledo Blade Co.,* 11 T.C. 1079; *Aaron Michaels,* 12 T.C. 17.

The advantage to the buyer of having the covenant not to compete in the contract was that a valuable right was acquired for a definite consideration which had a definite life, and in addition to being transferable, was subject to amortization.[51]

Since the amount allocable to any agreement not to compete would be considered as ordinary income, the seller, where required as part of the sale to agree not to compete, should strive to minimize and specifically state the amount assignable to such agreement rather than have it all included in the price of good-will subject to a later and possibly larger allocation by the Commissioner.

8. Allocations, Valuations and Basis in General

While reference has not been made to it in the cases, the solicitation of offers to help establish the fair market value of the assets for the purpose of projecting the probable tax consequence upon the liquidation of a corporation, might be a practice to be avoided where there is the possibility that the distributee stockholders will sell the assets on their own. In addition to having complete and accurate inventories taken of all assets, an appraisal should be made of all the properties by a competent, reputable, independent appraiser who is familiar with the type of business in question.

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[47] *Estate of Mildred K. Hyde,* 42 BTA 738 (1940).

[48] *J.S.L. Restaurants, Inc.,* par. 51,056 Prentice-Hall Memorandum TC (1951).

[49] 19 T.C. 718 (par. 19.88 P.-H. TC 1953) (Taxpayer appealed to 10th Cir. 4-24-53).

[50] 13 T.C. 143 (1949) appeal dismissed (10 Cir. 1950) 180 F. 2d 354, 39 AFTR 4. Also see *Beals Estate* v. *Commissioner* (2 Cir. 1936) 82 F. 2d 268, 17 AFTR 621, affirming 31 B.T.A. 966 (1934).

[51] *Gazette Telegraph Co.,* 19 T.C. 692 (par. 19.86 P.-H. TC 1953).

When it comes to the sale of assets, if the parties do not allocate the price among the assets, the Commissioner will require an allocation and will likely insist that allocation be made on the basis of fair market values. Thus, difficulties may arise which might otherwise have been avoided if the allocation had been made in the sales agreement. Higher allocation to capital assets where a gain is expected will, of course, favor the seller. So long as the parties act reasonably, the allocations will ordinarily be respected even though they may differ somewhat from fair market values.[52] If wholly unrealistic and illogical allocations are made, the Commissioner may make his own determination. Further evidence of the importance of the allocation of the contract price to the various assets by the parties themselves can be found in *American Fork & Hoe Co.*[53] and *Republic Steel Corporation* v. *U.S.*[54]

The distribution of assets to the stockholders in liquidation of a corporation under 1954 IRC § 331(a) (1939 IRC § 115(c)) is a recognized taxable event, the measure of the gain to the stockholders being the difference between the fair market value of the net assets received and the stockholders' cost basis for the stock. All this presents the usual difficult question of valuation, especially where the valuations of good-will or other intangible assets are involved. Therefore, consideration must be given to such problem in planning a liquidation, and due regard given to the matter of getting appraisals by reputable independent appraisers. The appraisals should, of course, be preserved for immediate reference when needed.

There will be the problem of determining the cost basis of the stock for purposes of computing the stockholders' gain, whether upon the sale of the stock to others, or its redemption by the corporation in exchange for assets. The original cost may subsequently have been effected as, for example, by distributions to the stockholders by the corporation that were not out of earnings and profits which would reduce cost or by capital surplus contributions made by the stockholders which would increase cost. Also, the stock, or some of it, may have been acquired other than by purchase, as, for example, by gift or inheritance, which may require some investigation to establish the correct tax basis.

An interesting situation concerning the valuation of assets arose in *Standard Realization Company*,[55] which was a corporation formed for the purposes of selling assets received by stockholders on the liquidation of another corporation. There, a previous corporation distributed its assets and was dissolved, whereupon the distributee stockholders in turn contributed the assets to a new corporation, Standard Realization Company, which sold the assets. It was held that the valuation of the assets chargeable to the stockholders in liquidation of the previous corporation was the same as the selling price of said assets by the Standard Realization Company.

9. Consideration of Losses

If a net loss due to the sale of the assets of a business is to result, then questions concerning its treatment must be considered. In any case, there apparently is no restriction to offsetting against the income of the year of sale losses resulting from the *bona fide* sales of the real and depreciable property of the trade or business. However, where the income for the year is not sufficient to absorb such losses fully, problems concerning the treatment of the excess loss arise.

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[52] *Fraser* v. *Nauts*, 8 F. 2d 106 (D.C., N.D. Ohio W.D., 1925), 5 AFTR 5600.

[53] 33 B.T.A. 1139 (1936).

[54] 94 Ct. Cl. 476, 40 F. Supp. 1017, 28 AFTR 175 (1941).

[55] 10 T.C. 708 (1948).

Considering the language of Section 122(d)(5) of the 1939 Code and its application in *Hartwig N. Baruch,*[56] it became apparent that the treatment of such losses by corporations differed from that accorded individuals. With respect to individuals, it was held in *Joseph Sic*[57] that unless the taxpayer regularly engaged in the business of selling or liquidating the type of asset or business involved, any loss sustained on the sale or liquidation will be treated as an isolated loss that may not be applied as a net operating loss carry-back or carry-over. In *Joe B. Luton,*[58] a loss on the sale of equipment used in a sole proprietorship was disallowed as part of the net operating loss resulting from the regular activities of the business. In this *Luton* case, the Tax Court held that the losses on the sale of the equipment constituted "non-business losses" to be offset against "non-business income" (salary and interest income) after which the net operating loss from regular operations (computed without regard to the loss on the sale of the equipment) is to be offset against any income remaining. In *Louis E. Whitham,*[59] which involved an individual, the gain on the sale of the business equipment was applied as an offset against a capital loss resulting from the sale of capital assets, rather than as an offset against the net operating loss resulting from the operations of the business. Beyond that point, the excess loss, having resulted from the regular business activities, could be treated as a net operating loss.

In *Roman S. Gontarek,*[60] the decision disallowed the treatment of a loss on the sale of machinery and equipment as part of the net operating loss of a partnership, citing *Sic* v. *Commissioner,*[61] thus, what had been held for losses of individuals must be considered as equally applicable to partnerships under the 1939 Code.

Mindful of the disparity of treatment of such losses under the prior law, as between corporate and other taxpayers, and the resulting patent inequity, Section 172(d) of the 1954 Code was enacted. Thereunder, any loss from the sale or other disposition of real property used in the trade or business or of property of a character which is subject to the allowance for depreciation, may be used as part of the net operating loss to be carried back or forward. This provision apparently applies whether the entire business is sold or only one or some of the business assets are sold and the business is continued.[62]

With respect to expected losses from the sale of the assets of a sole proprietorship or partnership, there may be other combinations of gains and losses to consider. For example, if both a capital gain and an ordinary loss is to result, there is still this same problem of the extent to which the latter may be absorbed if it exceeds the capital gain so that the other income and deductions of the individuals, aside from those relating to the sale of the assets, must be taken into account.

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[56] (2 Cir. 1949) 178 F. 2d 402, 38 AFTR 1040 affirming 11 T.C. 96.

[57] *Joseph Sic* v. *Commissioner* (8 Cir. 1949), 177 F. 2d 469, 38 AFTR 804, Cert. denied 339 U.S. 913 (1950), affirming 10 T.C. 1096 (1948).

[58] 18 T.C. 1153 (par. 18.144 P.-H. TC 1952).

[59] *Louis E. Whitham,* par. 53,031 Prentice-Hall Memorandum TC (1953).

[60] Par. 52,025 Prentice-Hall Memorandum TC (1952), appeal to 6 Cir. dismissed (1952).

[61] Footnote 57, above.

[62] Report of Senate Committee on Finance to accompany HR 8300, p. 212.

A loss on a sale to a corporation controlled by the seller would be unallowable pursuant to 1954 IRC § 267 (1939 IRC § 24) so where such a loss is expected, consider the possibility of a tax free exchange under 1954 IRC § 351 (1939 IRC § 112).

As for corporations, where a corporation sustained a loss in the process of liquidation, a net operating loss carry-back was permitted in *Acampo Winery & Distilleries, Inc.*[63] Further comments concerning losses by corporations are made in this chapter under the title of "Sale of Assets by the Corporation." In the past, where a profitable business was to be contributed to a loss corporation, the accumulated net operating losses were often an important factor in the acquisition, particularly in view of the five year period available for carry-over purposes.[64] Clearly, this was a tax advantage being given by the seller of the stock of the corporation, since it automatically went along to the buyer through a continuation of the corporation as a tax entity. As a result, the practice of buying and selling "loss corporations" became widespread. In an effort to bar such acquisitions, Section 129 of the 1939 Code provided that where a controlling interest in a corporation is acquired for the purpose of avoiding or evading tax liabilities, the Internal Revenue Service might disallow benefits of a deduction, credit, or allowance which would otherwise be enjoyed by the acquiring person or corporation. In practice, the statute proved highly ineffectual due to the necessity of proving that tax avoidance was the primary purpose of the transaction. At the same time, the undefined scope of the provision cast a shadow of possible tax litigation which discouraged many valid business transactions.

The 1954 Code contains several sections designed to erect additional obstacles to the purchase of loss corporations. First, under Section 269(c), the law creates a *prima facie* case in favor of the Commissioner, that the property was acquired for purposes of tax avoidance where it appears that in regard to an acquisition made after March 1, 1954, the buyer paid substantially less than the total of (a) the tax basis of the corporate property received, and (b) other tax benefits, such as loss carry overs.

Further, under Section 382, if 50 per cent or more of a corporation's stock changes ownership during a two year period as a result of the purchase or redemption of stock and, in addition, the corporation changes its trade or business, any net operating loss carry-overs are entirely lost. Where the stock is acquired by purchase, there is no restriction on the carry-over, so long as the corporation does not change the line of its trade or business. It would appear that the effect of these provisions is to narrow the market considerably for vendors of "loss corporations."

10. Formalities to be Considered

On dissolution, the mere fact that the stockholders are to take title to the assets should not alter the situation as to the formalities of transfer. Certainly, records should be set up for the accounting of the assets acquired similar to the situation where a corporation is dissolved and the former stockholders operate as a partnership or joint venture—all instruments of conveyance should be properly recorded. All the required formalities are not just accomplished for the benefit of some tax motive, but rather, good business conduct dictates adherence to formality in all such matters. When property is purchased on the open market, immediate steps to evidence ownership, as may be required by all the formalities, would be taken so that there is no reason why there should be any difference concerning property acquired from a liquidating corporation.

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[63] 7 T.C. 629 (1949).

[64] 1954 IRC § 172(b); 1939 IRC § 122(b)(2)(B).

In *Doyle Hosiery Corporation*,[65] the dissenting opinion of the Tax Court referred to "all that was done by the stockholders in their individual capacities was to indulge in carefully clocked ritualistic formalities." In *Cumberland Public Service Co.*,[66] the dissenting opinion had this to say: "It supplies no formula for transforming ritual into reality by a lip service recitation of fundamental principles." It seems evident from these dissenting opinions that the "ritualistic formalities" were important under the law then applicable, and while the stated purpose of Congress in enacting Section 337 of the 1954 Code was to counteract the undue weight accorded by the courts to the formalities of such a transaction, it is nevertheless only common prudence to establish an unequivocal and complete record of the transaction.

The "genuine liquidation" factor which was noted in *Cumberland Public Service Co.*[67] and which is evidently one of the controlling factors in such case was mentioned again in *Isidore P. Klous, et al.*[68] In holding for the taxpayer in that case, that the gain on the sale of the assets received from the corporation may not be imputed to the corporation, following *Cumberland Public Service Co.*[69] and *Doyle Hosiery Corporation*,[70] the court found as facts: ". . . that the corporation did not authorize, negotiate or make any sale of its property prior to liquidation, the distribution in liquidation was genuine, and that therefore petitioners (stockholders) made the sale on their own behalf as the individual owners thereof."

The statutory broadening of the rule of the *Cumberland* case under the 1954 Code still makes requisite the adoption by the corporation of a plan of liquidation. Therefore, despite the relatively clear status of the present law, it would appear that a double tax may still be imposed in the case of a liquidation and sale of the corporation's assets at a profit, if the transaction is improperly handled. In *E. P. Gensinger, Transferee*,[71] there appears to be a complete lack of formality required to effect a liquidation in dissolution prior to the sale of assets. Evidently the court felt the same way because in holding that the income from the sale was taxable to the corporation rather than to the stockholder, following *Court Holding*[72] and *Fairfield Steamship Company* v. *Commissioner*,[73] it said in its opinion with regard to the stockholder that "he testified that he took over the assets of the corporation subject to its liabilities on July 17, 1943, but that conclusion is not supported by any act other than perhaps his mental process." In this *Gensinger* case the Tax Court got tangled up in the Washington state law, and it seems to have gone beyond the point of genuine liquidation by stating when the corporation was actually dissolved. Section 29.115-9 of Regulation 111, which dealt with the redemption or cancellation of the stock of a corporation, makes mention of formalities when it says: "If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend." If all operations with respect to the liquidation are wound up within the one year period, it would seem to be one sure way to avoid any potential tax difficulties that periodic distributions in a drawn out liquidation might invite. In this connection it is well to note that an explicit plan of liquidation is now an essential requirement of even a partial liquidation under the 1954 IRC, and the regulations, when published, will no doubt demand the requirement for complete liquidations. To fail to reduce a plan of liquidation to the form of a corporate resolution in the future, under these circumstances, is sheer folly.

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[65] 17 T.C. 641 (par. 17.70 P.-H. TC 1951).

[66] Footnote 17, above.

[67] Footnote 17, above.

[68] Par. 52,105 Prentice-Hall Memorandum TC (1952).

[69] Footnote 17, above.

[70] Footnote 65, above.

[71] 18 T.C. 122 (par. 18.17 P.-H. TC 1952) (Taxpayer has appealed to 9 Cir. 10-10-52)

[72] Footnote 16, above.

[73] (2 Cir. 1946) 157 F. 2d 321, 35 AFTR 117, affirming 5 T.C. 566 (1945) Cert. denied 329 U.S. 774 (1946).

Once the decision is made concerning the sale of a corporate business proper, authoritative resolutions should be adopted in the minutes giving the reasons for the action to be taken concerning dissolution, and setting forth the general plan of liquidation. It may be beneficial to stress that the resolution and plan should be promptly carried out. Distributions in liquidation should be approved in the minutes and clearly earmarked as such. Information should be furnished to the Commissioner of Internal Revenue pursuant to the provisions of Section 6043, 1954 IRC (Section 148, 1939 IRC) and related sections 29.148-2 and 148-3 of Regulations 111. The winding up and dissolution of the corporation must, of course, follow any pattern prescribed by the state law such as tax clearance, advising creditors, and other interested parties, redemption of the stock, etc. From all this it may appear that undue weight should be given to formalities as to the way things are done rather than to the actual effect, or that viewed realistically the economic result may be the same regardless of how the transaction is brought about. Nevertheless, the adherence to formalities in matters pertaining to the sale of a business is not necessarily an exaltation of form over substance, since it falls in line with clean cut business planning and the shaping of affairs so that they may receive the most favorable consequences possible for all purposes. A comparison of *Court Holding Co.*[74] with *Cumberland Public Service Co.*[75] clearly indicates that taxability under the law then applicable depended on the way the transaction was carried out, and not on the economic effect. Things which were to be *avoided* if the corporation was not to be taxed under the prior law were:

1. Sale after liquidation by stockholders at the price and the terms similar to those negotiated before liquidation.
2. Conducting negotiations with the buyer by directors or officers of the corporation.
3. Negotiation of sale by trustee-in-liquidation of corporation.

So, where possible, and as a cautionary measure, any negotiations for the sale of the assets by anyone (where it was not the intention to have the corporation make the sale) should have been completely deferred until the corporation had been liquidated and steps taken toward dissolution; a complete legal transfer of the properties from the corporation to the stockholders had been made and with no strings attached. Where steps relating to actual negotiation for the sale of the assets by the stockholders for some reason had to be taken before liquidation and before steps had been taken toward dissolution by the corporation, then the negotiations should have been conducted by one acting on behalf of the stockholders rather than the corporation; the negotiators should not have been a party in any way connected with the corporation as officers, or stockholders, or directors, or related to any of them; and it should have been made clear from the start that the negotiator is acting on behalf of the stockholders and is so acting on their authority. The stockholders' agreement to sell in *Cumberland* seems to have covered the situation very well.

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[74] Footnote 16, above.

[75] Footnote 17, above.

On the basis of the substantive changes made by the 1954 IRC previously alluded to herein, many of these evidentiary taboos have been dispelled. It would appear that under the present law the line of delineation which must not be crossed if the sale of corporate assets is not to be imputed to the corporation (and on which no election regarding gain or loss can be made) would be the date of the adoption of a plan of liquidation. The negotiation by and disposal of corporate assets by the corporation thereafter (within the limitations set forth in Section 337, 1954 IRC) would no longer give rise to gains upon which the corporation would be taxable. However, where negotiations are carried on by the corporation with prospective purchasers before the adoption of a plan of liquidation, it would appear that the courts may once again revert to the formalisms as a basis for their decisions. For this reason, consideration of the evidentiary matters accorded weight in prior cases can be extremely instructive.

Since the stock is merely a symbol of an interest in the underlying net assets, the stockholders are attempting to reach the same end through a sale of assets in liquidation as would result from a sale of their stock. If the avoidance of the double tax may depend on the mechanics of the thing, then it is worth the effort.

Variations on the mechanics of producing a desired result called forth by a particular factual situation should not be overlooked. An interesting set of facts relating to this matter of the sale of stock or the assets and formalities concerning dissolution and distributions to stockholders appear in a 1953 Tax Court case, *Anna B. Negus, et al.*[76] Because a number of the corporation's stockholders were scattered throughout the country, it was considered unwise to attempt a sale of the stock. A recommendation was also followed that solicitation of all offers and negotiations for the sale of assets by the corporation be discontinued and that the corporation be liquidated by a distribution of its assets in kind to the stockholders and the corporation dissolved. The assets were duly transferred to the stockholders who in turn formally transferred them to a trust created for the specific purpose of liquidating the assets. The trust operated the properties for over a year before finally selling them for the benefit of the ex-stockholders of the dissolved corporation, and during that period realized a profit from operations. The Commissioner contended that the trust was merely a continuation of the business of the corporation and so should be taxed as a corporation. The Tax Court held against the

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[76] Par. 53,075 Prentice-Hall Memorandum TC (1953).

Commissioner, following *Helvering* v. *Washburn*,[77] wherein it was held that a trust formed for purpose of liquidation as soon as circumstances will permit and the carrying on of business is only incidental and necessary for the preservation of the trust property is not an association taxable as a corporation. In *Washburn*, it was pointed out that the transaction of some necessary business is not fatal to a strict trust, tax-wise, for the reason that there is scarcely any trust whose administration does not necessarily involve the doing of some kind of business.

The case of *Acampo Winery & Distilleries, Inc.*[78] considered the problem of determination of who was the seller with respect to gain from the sale of assets of a corporation, and whether the trust created by the stockholders was acting as trustee-in-liquidation on behalf of the corporation. There were several hundred stockholders; a trust was created to act for the stockholders to care for the assets until they could be sold; none of the three trustees elected by the stockholders were officers or directors of the corporation; various instruments pertaining to the trust expressly provided that the trustees were authorized to act only for the stockholders and were not authorized in any way to act for the corporation. The assets were distributed in liquidation to the trustees for the stockholders. Appropriate resolutions were adopted and appropriate conveyances of title made by the corporation. No deal of any kind for the sale of the assets was pending prior to the distribution in liquidation. Several weeks before the conveyance to the trustees, a majority of the stockholders consented to dissolution after which steps leading toward dissolution were promptly taken. Approximately one month after the receipt of the assets which they had advertised and made other efforts to sell, the trustees sold them. The Commissioner was contending that the trustees were trustees-in-dissolution acting for and on behalf of the corporation, citing *Mrs. Grant Smith*[79] and *First National Bank of Wichita Falls, Trustee.*[80] In distinguishing this case from others, and finding that the sale was not made by the corporation, the Court said: "The negotiations which led to the sale in the present case were begun after the liquidating distribution, were carried on by trustees elected by and representing only stockholders, were not participated in by the corporation in any way, and had no important connection with any prior negotiations."

In the sale of a partnership business in which the transaction was held to be a sale by the partners of their partnership interests (Capital Assets) rather than a sale of assets by the partnership, the Court also considered formalities when it indicated that the language used in the contract that was involved or the methods which were used to effect a transaction may not be disregarded but rather, the form and steps used in their relation to the intended and accomplished entire transaction must be considered.[81] Care must be taken to avoid ambiguity in documents, as evidenced by the decision in *Wichita Terminal Elevator Co.* v. *Commissioner*,[82] where it was held that the sale of the assets was made by the corporation through its liquidating agent.

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[77] (8 Cir. 1938) 99 F. 2d 478, 21 AFTR 1140, affirming 36 B.T.A. 1328 (1937).

[78] Footnote 63, above.

[79] 26 B.T.A. 1178 (1932).

[80] 3 T.C. 203 (1944).

[81] Footnote 34, above.

[82] (10 Cir. 1947) 162 F. 2d 513, 35 AFTR 1487, affirming 6 T.C. 1158 (1946).

11. Capital Gains and Non-Capital Gains

While many would like to look at the sale of an entire business as just a sale of another capital asset on which the tax on the gain to the seller would be limited to no more than the maximum capital gains tax, the limitations that attach where capital losses are sustained in such transactions cannot be overlooked. It might be said generally that, with respect to gains, the seller ordinarily will want capital gains rather than ordinary income. A taxable distribution in liquidation of a corporation will usually constitute a capital gain or loss to the stockholders where the business does not come within the provisions of 1954 IRC § 341 (1939 IRC § 117(m)) dealing with collapsible corporations.

Where the corporation being liquidated has earnings and profits, consider the following:

1. Liquidation to stockholders should be timed so as to follow and not precede the steps formalizing the beginning of liquidation to assure the benefit of the capital gains treatment.
2. Where the corporation to be liquidated is dominated by another corporation which owns less than the required 80 per cent of all classes of the voting stock to make the liquidation tax-free under Section 332, 1954 IRC (Section 112(b)(6) 1939 IRC), its surplus might best be distributed as an ordinary dividend prior to commencement of formal liquidation. This would be best where the application of the 85 per cent dividends received deduction as permitted by Section 243, 1954 IRC (dividends received credit under Section 26(b), 1939 IRC) makes such a distribution less expensive than realization of capital gain by the corporation receiving the distribution.

Of course, the determination of what might be capital assets and non-capital assets under the circumstances of the particular situation would generally have to be determined according to the type of trade or business in which the sellers are engaged with due regard being given to the nature of the assets and the provisions of Subchapter P, 1954 IRC (Section 117, 1939 IRC).

In *Susan J. Carter* v. *Commissioner*,[83] a corporation reporting on the cash basis distributed among other assets, pursuant to liquidation, certain brokerage contracts providing for payment of commissions to the corporation. Such contracts had no ascertainable fair market value. Collections on the contracts which required no services by the distributee stockholders during the year following the distribution were treated as capital gains to the stockholders. Property purchased for business use and never used was held to be a 1954 IRC § 1231 (1939 IRC § 117(j)) asset in *Alamo Broadcasting Company, Inc.*[84] In *Graves Bros. Co.*,[85] it was held that a classification of property acquired for use in operation of a trade or business was not changed where the property ceases to be so used—to the opposite effect is *Stewart Title Co.*, par. 20.88 P.H. TC 1953.

Of course, the holding period is important concerning the tax treatment of capital gains and an oddity in that regard is that the holding period of a capital asset received in a non-taxable exchange includes the holding period of the non-capital asset.[86] In *Gracey, et al.*,[87] there was a tax-free exchange, under what is now Section 351, 1954 IRC (Section 112(b)(5) 1939 IRC) of non-capital assets of a sole proprietor for capital stock of a newly organized corporation. About a month after the exchange, Gracey sold part of the stock and was upheld in treating the gain as a long-term capital gain, taking into account the holding period of the non-capital assets. At the present time, consideration must be given to the effect that the provisions of 1954 IRC § 341 (1939 IRC § 117(m)) relating to collapsible corporations would have on situations of this kind.

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[83] (2 Cir. 1948) 170 F. 2d 911, 37 AFTR 573, affirming 9 T.C. 364 (1947).
[84] 15 T.C. 534 (1950).
[85] 17 T.C. 1499 (par. 17,186 P.-H. TC 1952).

12. Methods of Reporting Income

1954 IRC § 453(d) (1939 IRC § 44(d)) and Section 39.44-5 of Regulation 118, relating to gain or loss upon disposition of installment obligations where assets of a taxpayer reporting on the installment basis are distributed, sold, or otherwise disposed of, are factors to be considered. Upon the sale of the assets, the entire balance of the gain or profit previously deferred under Section 453(d) 1954 IRC (Section 44(d) 1939 IRC) with respect to installment obligations will become immediately taxable to the seller. Where such installment obligations resulted from the sale of inventories or property otherwise held primarily for sale to customers, it will be ordinary income. Where a corporation under Section 337 of the 1954 Code makes a liquidating distribution of certain installment obligations, gain or loss is realized by the corporation under 1954 IRC § 453(d) to the extent of the difference between the basis of the obligation and the fair market value of the obligation at the time of the distribution.

The need for making proper provisions for all deductions is important because an item which might be an ordinary deduction to the corporation would only be a capital loss to the transferee stockholders subsequent to liquidation.[88] Remember that organization and any reorganization expenses of the corporation are allowed as deductions on the final return of a dissolved corporation. It makes no difference if over the years such items may have been charged off and so no longer appear as an asset on the books—they are allowable as deductions in computing taxable income on the final return. This would not be true however where the corporation has elected under Section 248 of the 1954 Code to write off its organization expenses incurred on or after August 16, 1954 over a period of not less than 60 months beginning with its first active business month. However, since no such election can be made in regard to reorganization expenses, they should still be deducted on the final return of the corporation.

The method of reporting income by a corporation as affecting its tax on operations can be important upon liquidation. In *P. J. Lynch*,[89] a corporation that followed its previously acceptable custom of reporting warehousing expense on the accrual basis and storage income upon issuance and payment of the bill after withdrawal of the goods by its customer, was nevertheless held to be taxable on the storage charges remaining uncollected upon its liquidation. In *Mabel Moore Floyd, Extrx.* v. *Scofield*,[90] a corporation reporting on the cash basis sold and delivered to some of its customers oil and gas which it produced. Prior to the collections for such sales, the corporation adopted a plan of liquidation and dissolution. Checks in payment were received after adoption of such plan but before dissolution. In distributing the proceeds direct to the stockholders, the corporation claimed it realized no income because it reported on the cash basis and had not received the funds prior to the adoption of the plan of liquidation. The income was held to be taxable to the corporation. In a similar case where the corporation prior to dissolution had been on a cash basis, certain sums subsequently received were taxed to the corporation under 1939 IRC § 41 [91] (1954 IRC, Subchapter E, Part I). That the sale by an accrual basis taxpayer was completed in the year the property was transferred was another issue decided in *Evansville Oil Corporation*.[92] According to *Plaza Investment Co.*,[93] where the dissolution of the corporation did not terminate the lease, the benefit to be derived from an expenditure pertaining to such lease will continue until the expiration of the term of lease.

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[86] G.C.M. 25,301, 1947-2 C.B. 83 citing *Commissioner* v. *Gracey, et al.* (5 Cir. 1947), 159 F. 2d 324, 35 AFTR 680 affirming on this part 5 T.C. 296 (1945).

[87] *Commissioner* v. *Gracey, et al.*, footnote 85, above.

[88] *Arrowsmith, Exec.* v. *Commissioner* 344 U.S. 6, rehearing denied 344 U.S. 900, affirming *Commissioner* v. *Bauer* (2 Cir. 1952), 193 F. 2d 734, reversing 15 T.C. 876 (1950).

[89] *P. J. Lynch* v. *U.S.* (9 Cir. 1951), 192 F. 2d 718 (par. 72,665 P.-H. Fed. 1951 and par. 72,332 P.-H. Fed. 1951).

It may be possible to delay a sale to bring it over into the lower tax rates of the following year. There may be some advantage to this where there will be some ordinary income realized on the sale and a lower net income or a tax rate reduction is expected in the later year. In any event where the transaction is to take place near the close of the taxable year any advantages and disadvantages of immediate consummation of the sale as against its delay must be weighed. If a corporation would be vulnerable to 1954 IRC, Subchapter G, Part I (1939 IRC § 102) unless a substantial dividend was paid prior to the close of the year, the liquidation before the end of the year would affect a potential saving of the accumulated earnings tax. The need for distributing any part of the current earnings of the corporation as an ordinary dividend would also be avoided. An important factor in deciding to make the sale in one year as against the next would be the effect of any loss carry-over as a possible offset against the profit on the sale of assets.

13. Conclusion

It would seem to be good practice to make inquiry of the client from time to time concerning any thoughts he may have about selling the business and to suggest that, should he ever consider it, to be sure to discuss the matter fully with counsel before making any commitments of any kind.

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[90] (5 Cir. 1952) 193 F. 2d 594 (par. 72,238 P.-H. Fed. 1952), affirming D.C., W.D. Tex. 1951 (par. 72,348 P.-H. Fed. 1951).

[91] Footnote 83 above. To the same effect, *Jud Plumbing & Heating Inc.* v. *Commissioner* (5 Cir. 1946), 153 F. 2d 681, 34 AFTR 1025 affirming 5 T.C. 127 (1945).

[92] Footnote 14, above.

[93] *Plaza Investment Co.*, 5 T.C. 1295 (1945).

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Gains and Losses on Sales and Exchanges of Business Property

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I

THE RULES

1. Points to Consider

It is necessary to know:

	Section
The difference between ordinary gains and losses and capital gains and losses	2
How assets are classified	3
What assets are "business property"	4
How gain or loss is determined	5
The holding period of the property	6
What the rules are for gains	7
What the rules are for losses	8

(See also table at beginning of part II, this chapter.)

2. Ordinary Gain or Loss Versus Capital Gain or Loss

Sales or exchanges of property result either in ordinary gain or loss or in capital gain or loss, depending upon the class of asset involved. An ordinary gain is fully taxable as ordinary income; an ordinary loss is fully deductible. A capital gain may be given very favorable tax treatment if the property was held for over six months by being taxed at a maximum of 25 per cent; a capital loss is deductible only to a limited extent.

3. Classification of Assets

There are four general classifications of property, and each is accorded treatment which differs in some important respect from that given the other classes.

	Tax Treatment	
Classification	*Gain*	*Loss*
A. Ordinary Assets:		
1. Stock in trade or inventory	Ordinary	Ordinary
2. Property held primarily for sale to customers in the regular course of trade or business.	Ordinary	Ordinary
3. Real and depreciable property used in trade or business, held for six months or less.	Ordinary	Ordinary
4. Certain items which replace ordinary income when they are sold or which are specifically classified by the Code or court decisions as ordinary assets, such as: copyrights and similar property, certain short-term noninterest-bearing Government securities, noncompetition agreements sold, agency contracts for personal services, payments to a landlord to cancel a lease, patent license agreements, and shares in a collapsible corporation under some circumstances.	Ordinary	Ordinary
B. Section 1231 (1939 IRC 117 (j)) assets:* Real and depreciable property used in trade or business, held for more than six months[1] (not including any items listed in A)	Ordinary gain or loss or capital gain or loss, depending upon the circumstances covered in Section 1231 (1939 IRC 117 (j)).	
C. Capital assets:		
1. Property held for personal use	Capital	Nondeductible
2. Property used in trade or business which is not real or depreciable	Capital	Capital
3. Property held for investment	Capital	Capital
4. Any property not covered in the foregoing classes (A), (B), or (C)(1)(2)(3)	Capital	Capital

4. Business Property

The intrinsic nature of a piece of property does not govern its classification. Often the period of time the property has been held and the purpose for which it was acquired and held do assist in determining classification. For example, land may be (a) held primarily for sale to customers in the regular course of business,[2] (b) used in trade or business, (c) held as an investment, or (d) held for personal use.

"Business property" includes all property held for sale to customers, investment, or use in trade, business, or profession. It excludes property held by an individual for personal use or for personal investment other than in connection with rents and royalties. However, the rules for gain or loss on personal investments of individuals are generally the same as those for businesses.

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* All section references in the text material are to the 1954 Internal Revenue Code except those marked "1939 IRC."

[1] Twelve months if dairy, breeding, or draft animals.

[2] For convenience, this phrase will be shortened to "held for sale to customers" in most places in the rest of this chapter.

a. The nature of a trade, business, or profession. Since "business property" includes property held by a *business* (a) for sale to customers in the regular course of *business* and (b) for use in *trade or business*, it is necessary to know what "trade or business" means. "Trade" and "business" may be considered together with "profession" as covering business activities or attempts at producing income, other than as an employee or investor. This definition must be modified, however, to include in "trade, business, or profession" the ownership or operation of rental[3] and royalty-producing property. Investing in stocks and securities by nondealers (i.e., traders and investors) does not constitute a trade or business.

b. Differentiation between property held for sale to customers, for investment, or for use in trade or business. It is necessary to distinguish between the various kinds of business property because:

a. Stock in trade or property held primarily for sale to customers in the regular course of business results in ordinary gain or loss.

b. Property held for investment results in capital gain or loss (rental and royalty property being classified under c).

c. Real or depreciable property used in trade or business:
  1. Held for six months or less results in ordinary gain or loss.
  2. Held for over six months results in net capital gain or net ordinary loss, under Section 1231 (1939 IRC 117(j)), depending upon the factual situation.

d. Other property used in trade or business results in capital gain or loss.

Distinguishing between these classes is not always a simple and clear-cut matter. The purpose for which the property was acquired or held may be the deciding factor. However, in some instances, the nature of the asset may change from the time it was acquired and be different at the time it is disposed of. The difficulty of classifying a parcel of property is illustrated by a recent case.[4] A dentist inherited a part of a tract of subdivided land. He and the other heirs joined the parcels together and farmed the tract. Later they subdivided the land and sold the parcels over a period of several years to buyers who presented themselves unsolicited by the sellers. Should this land have been classified as (a) held for sale to customers (ordinary income), (b) held for investment (capital gain), or (c) real property used in trade or business (capital gain or ordinary loss under Section 1231 (1939 IRC § 117(j))? The court ruled the gain was capital gain. Section 1237 offers relief to subdividers under certain circumstances by treating subdivided property as capital assets rather than property held primarily for sale.

It may help to classify some specific common and important types of property to illustrate the possibilities under various circumstances. (See page 1073.)

Perhaps, sufficient examples have been given to emphasize the point that one must look for the intent of the taxpayer in his acquisition and holding of the property and the use, if any, which is being made of the property at the time of its disposition. For example, a residence may be held by a real estate dealer primarily for sale to customers (ordinary gain or loss), by a taxpayer who holds it as rental property (used in trade or business and a Section 1231 (1939 IRC 117(j))

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[3] *Hazard*, 7 T.C. 372, acq. 1946-2 C.B. 3.

[4] *Wells* v. *Kelm*, D.C., Minn., 4th div., Civil No. 3645, April 28, 1952.

	BUSINESS PROPERTY			PROPERTY HELD FOR PERSONAL USE OR INVESTMENT
	Held For Sale — Ordinary Asset	Capital Asset[5]	Real and Depreciable Property Used in Trade or Business—Sec. 1231 (1939 IRC 117(j)) Asset	Capital Asset[6]
Residence and land	x		x	x
Vacant land	x	x	x	x
Patents	x	x	x	x
Merchandise sold	x			
Securities	x	x		x
Interest in a venture or partnership		x		
Good-will		x		
Noncompetition agreement	x		x	
Bank account (cash)		x		
Accounts and notes receivable collected	x			
Accounts and notes receivable sold (acquired for services or stock in trade)	x			
Recoveries of debts written off	x			
Interest in a proprietorship	x	x	x	

asset if held over six months), or by an individual as a personal living place (capital gain or non-deductible loss). A patent may be held for sale to customers, as a capital asset, used in trade or business, or even as a personal hobby or amusement. Merchandise in almost all instances can be classified only as held for sale to customers. Interest in a joint venture or partnership is held only as a capital asset, with the exception of amounts related to unrealized receivables or appreciated inventory[7] and that part equal to the seller's share of partnership net income of the current year;[7a] an interest in a proprietorship, on the other hand, is considered to be a holding of the underlying property, a holding of a mixture of property held for sale to customers, for investment, and for use in trade or business (Rev. Rul. 55-79, I.R.B. 1955-7). It is possible, however, for partnership property rather than an interest to be sold.[8] The Tax Court has ruled (*Busche*, 23 T.C. No. 92) that a loss on the sale of partnership assets to a corporation and liquidation of the partnership may be disallowed under Section 267 (1939 IRC 24(b)(1)(B)). Securities may be held by a dealer for sale to customers or by a trader or investor as investments, or by a person in the several capacities of dealer, trader, and investor. If such is the case, the securities must be segregated into the respective classes. Securities are not *used* in a business nor held for personal *use*. Goodwill and trade names are property used in trade or business, but they are not real and very seldom are depreciable; consequently, they are almost always capital assets and not Section 1231 (1939 IRC 117(j)) assets nor ordinary assets. A non-competition agreement usually results in ordinary income to the seller who agrees not to compete, although it is depreciable property used in the trade or business of the purchaser. Bank accounts and receivables are used in trade or business but are not real nor depreciable, and, therefore, are capital assets. The collection or sale of accounts receivable acquired for services rendered or stock in trade results in ordinary income and not capital gain.[9]

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[5] Includes investment property (but not rental or royalty property) and nonreal and nondepreciable property used in trade or business.

[6] Gains are taxable capital gains; losses are nondeductible, because they are personal noncasualty losses.

[7] 1954 IRC §§ 741 and 751(a).

[7a] *U.S.* v. *Snow*, (9 Cir. 1955), par. 72,691 P.-H. Fed. 1955.

[8] Hatch, 14 T.C. 251.

To make this discussion a bit more tangible and concrete, the following cases are enumerated. The taxpayer in each case was considered to have gains or losses, as indicated:

Situation	*Ordinary*	*Capital*	*Section 1231 (1939 IRC 117(j))*
a. Sale of property acquired on foreclosure by a bank (*Kanawha*, 4 TC 252; GCM 24910; not sale in regular course of business)		x	
b. Sale of vacant lots acquired upon the liquidation of an unsuccessful corporation (*Leedy and Company, Inc.*, TC Memo, Docket No. 17630, Aug. 12, 1952; not a sale in the regular course of business)		x	
c. Sale of a lot at a loss, bought for business use but not so used because of zoning laws (*Davis*, 11 TC 538)		x	
d. Inherited jewelry always held for sale (*Reynolds*, CCA 1, 155 F. 2d 620 (1946); not held for sale in the regular course of business)		x	
e. Stock in trade sold upon the liquidation of a business (*Grace Bros.*, CCA 9, 173 F. 2d 170 (1949))	x		
f. Sale of a mill (depreciable property) taken over in settlement of a debt but not used in the taxpayer's trade or business (*Lee, Wilson & Co.*, TC Memo)		x	
g. Sale of equipment in an abandoned mine (*Providence Coal Mining Co. v. Glenn*, 88 F. Supp. 975 (1950); not used in trade or business)		x	
h. Leasehold sold by a tenant and subject to depreciation and used in trade or business (*Pekras*, CCA 6, 139 F. 2d 699 (1943))			x

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[9] 1954 IRC § 1221(4); *Sherwood*, 20 T.C. 733 (1953).

Situation	Ordinary	Capital	Section 1231 (1939 IRC 117(*j*))
i. Leasehold not subject to depreciation and sold by a tenant (*Sutliff*, 46 BTA 446)		x	
j. Sale of copyrights, literary, musical, or artistic compositions, or similar property if held by the creator or one who uses the creator's basis (I.R.C. Sec. 1221 (1939 IRC 117(a)(1)), 1231 (1939 IRC 117(j))	x		
k. Sale of a proprietorship (*Williams* v. *McGowan*, 152 F. 2d 570)	x	x	x
l. Sale of an option to buy property (*Milliken*, CCA 2, 196 F. 2d 135 (1952))		x	
m. Sale at a loss of equipment purchased by a United States radio station for use in its business and which a foreign government would not permit to be exported to the United States (*Alamo Broadcasting Co.*, 15 TC 534) (However, see *Burns*, 21 TC 847)			x
n. Property acquired for use in trade or business does not lose its character merely if it ceases to be actively used (*Graves Bros. Co.*, 17 TC 1499)			x
o. Collection of account receivable by a cash basis taxpayer (*Sherwood*, 20 TC 733)	x		
p. Sale of customers' accounts (*Graham Mill & Elevator Co.* v. *Thomas*, 152 F. 2d 564)		x	

c. Rental and royalty property. A person who holds rental and royalty property for the rentals and royalties they produce is in a trade, business, or profession, and the property is considered to be used in trade or business. A taxpayer who owns and operates real estate is deemed to be in a trade or business even though he has another occupation, devotes very little time to the property, owns no other parcel of property, the rental income is only a small part of his total income, and he may have used it as a personal dwelling prior to its conversion into rental property.

Patents and copyrights, of course, might be held also as ordinary assets for sale in the regular course of business or as capital assets for investment or speculation. Patents sold by an inventor are treated as capital assets. Copyrights; literary, musical, or artistic creations; or similar property held by the creator or one who derived his basis from the creator (for example, by gift) are specifically excluded from capital assets and Section 1231 (1939 IRC 117(j)) assets by the Code. A gain or loss on sale results in ordinary income or ordinary deduction. Copyrights so held are excluded from Section 1231 (1939 IRC 117(j)) even though they are depreciable, are used in trade or business, and have been held for over six months.

Oil and mineral lands held for the production of royalties are real property used in trade or business. The Tax Court (*Hawn*, 23 T.C. 516; *Nordan*, 22 T.C.

1132) and the Fifth Circuit Court (*Caldwell* v. *Campbell*, par. 72,352 P-H Fed. 1955) have held that a sale of an oil payment results in capital gain and is not the assignment of future ordinary income; however, the Internal Revenue Service does not acquiesce.

5. Determination of Gain or Loss

Gain or loss is the difference between the proceeds from disposition of property and the cost or adjusted basis of the property. It is necessary for the taxpayer to know: (a) the nature of the disposition, and (b) how to find the cost or other adjusted basis of the property.

a. The nature of the disposition. The taxpayer should know: (1) the nature of "sales or exchanges," (2) the nature of transactions which are not "sales or exchanges," and (3) the nature and effect of tax-free exchanges and transfers.

It is necessary to know the form of disposition because the form affects the taxability of a gain and the deductibility of a loss. Capital gain and loss rules apply mainly to *sales or exchanges* of capital assets and Section 1231 (1939 IRC 117(j)) assets, although they also apply under some circumstances to *involuntary conversion* of capital assets and Section 1231 (1939 IRC 117(j)) assets.[10] A gain on the involuntary conversion of property can be postponed if reinvestment of the proceeds of a recovery is done in a certain way and within a certain period of time.[11]

Abandonment and worthlessness result in ordinary losses (except in the case of property held for personal use) and are not considered as losses on sales, except in the case of securities of a corporation or government, issued in registered or coupon form. Foreclosure sales are sales and are not abandonment.

1. *What are "sales or exchanges"?* Many transactions are easily identified as sales or exchanges, but, for tax purposes, there are many other transactions which are considered as sales or exchanges although they cannot be easily identified as such. The picture is complex and cannot be reduced to one of complete order, logic, and coherence. The following transactions have been held to be sales or exchanges: surrender of a lease by a tenant for a consideration, redemption of capital stock and distributions in liquidation, sale of land for taxes, loss on certain worthless securities, failure to exercise an option, short sales, involuntary conversion in the nature of condemnation, and withdrawal in cash of an interest in a joint venture. The Tax Court (*Chicago Stoker Corp.*, 14 T.C. 441) has held that a lease with an option to purchase is a sale if the payments are large enough to exceed the depreciation and value of the property; the Fifth Circuit Court (*Benton,* 197 F. 2d 745) and a District Court (*Abramson, et. al.*, S.D. of Iowa, 1955, par. 72,853 P-H Fed. 1955) have held, however, that the intent of the parties governs. There are others, but this sample is enough to show that the concept of "sales or exchanges" is not clear-cut.

2. *Transactions not included in sales or exchanges.* It may help to see what transactions have been held *not* to be "sales or exchanges." The following, among others, are not sales or exchanges: redemption of capital stock equivalent to a

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[10] See discussion, under Section 7 of this Chapter.

[11] The same is true of sales only in the case of a personal residence.

taxable dividend, forgiveness of a contractual obligation, loan of property, gifts, sale of a right to receive ordinary income, abandonment of property, amounts received by a landlord to cancel a lease, surrender of a life insurance contract at a loss, payment received on the maturity of an endowment policy, "tax-free" exchanges, damages received for breach of contract, retirement of certain securities, and collection or sale of ordinary trade accounts receivable.

3. *Tax-free exchanges and transfers.* Exchanges basically are sales for a property consideration rather than for cash and affect gain or loss in the same way as sales. However, the Internal Revenue Code provides that certain exchanges shall be "tax-free." Actually they are tax-postponed rather than tax-free. Tax-free exchanges include:

a. Certain distributions and exchanges of stock, securities and property in corporate reorganizations.
b. Property held for productive use in trade or business or for investment, for property of like kind held for like use (not including stock in trade, capital stock, or securities).
c. Exchange of capital stock for stock of the same corporation under some circumstances.
d. Exchange of property for stock and securities when the transferor of the property immediately thereafter is in control of the corporation.
e. Exchanges in certain involuntary conversion situations.
f. Contributions of property to a partnership in exchange for an interest.
g. "Wash sales" at a loss of stock or securities (i.e., sales accompanied by a purchase of identical items within thirty days before or after the sale).
h. Exchanges of certain life insurance contracts.

In "tax-free" exchanges at a gain, gain may be partially recognized if cash or "other property" is received. Fundamentally, "tax-free" exchanges provide for postponement where the taxpayer is in substantially the same economic position after the exchange as he was before.

b. Adjusted basis of property disposed of. Gain or loss is the difference between proceeds from the disposition of property and the cost or other adjusted basis of the property. Buying property properly is important in having a basis which will give the best tax results. Since the subject of this chapter is *selling* property and not *buying* property, no more will be said here on the subject of buying and basis of property.

6. The Holding Period of the Property

The holding period is of importance only in connection with (a) capital assets and (b) real and depreciable property used in trade or business. Holding periods are either: (a) short-term, six months or less, or (b) long-term, over six months.[12] The rules for determining holding period have been laid down in a general way by the Code and Regulations and have been defined in more detail by a large number of court decisions. It is well to bear in mind that improvements made on land previously acquired do not have the longer holding period of the land; in a given case improvements might result in ordinary gain or loss (if held six months or less), while the land is eligible for the benefits of Section 1231 (1939 IRC 117(j)) (if it is held over six months).[13]

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[12] Except for dairy, breeding, and draft animals, in which case the dividing line is twelve months.

7. Rules for Gains

a. General. The sale of property held for sale to customers in the regular course of trade or business results in ordinary gain or ordinary loss. Capital gains and losses result from sales or exchanges of capital assets. Real and depreciable property held over six months and used in trade or business is covered by Section 1231 (1939 IRC 117(j)) and may result in a net capital gain or a net ordinary loss. Such property held six months or less gives ordinary gain or loss.

In addition to the rules for ordinary gains and losses and capital gains and losses, the taxpayer should know what Section 1231 (1939 IRC 117(j)) provides regarding: (a) the nature and purpose of Section 1231 (1939 IRC 117(j)), (b) the holding period covered, (c) the disposition transactions covered, (d) gains and losses included, (e) property covered, (f) how Section 1231 (1939 IRC 117(j)) operates, (g) treatment in tax returns, and (h) restrictions to plug loopholes.

b. Section 1231 (1939 IRC 117(j)).

1. Nature and purpose of section 1231 (1939 IRC 117(j)). This section was designed as a relief provision to reduce the tax on net gains but to let net losses be deductible in full. It treats net gains as capital gains and net losses as ordinary losses. This provision was introduced into the law as a World War II measure to encourage the transfer and sale of real and depreciable property to other enterprises which needed them to further war production. Prior to the enactment of this section, such gains were ordinary gains, because such assets are excluded from the definition of capital assets.[14]

Section 1231 (1939 IRC 117(j)) provides:

a. That although real property used in trade or business and depreciable property used in trade or business are not capital assets, under some circumstances they shall be given the benefits of being treated as capital assets.

b. That the assets must be held over six months (twelve for certain livestock).

c. That this special treatment applies only if recognized gains from the following assets and transactions exceed the recognized losses of the same sort:

1. Sales or exchanges of real property and depreciable property used in trade or business.
2. Involuntary conversions of:
   (a) Real property and depreciable property used in trade or business
   (b) Capital assets.
3. Cutting or disposal of timber, disposal of coal, and the disposition of unharvested crops, under some circumstances.

The treatment accorded under Section 1231 (1939 IRC 117(j)) is:

a. If gains from the foregoing sources exceed losses from such sources, the gains and losses shall be treated as long-term capital gains and losses.[15]

b. If losses exceed the gains, the gains and losses are treated as ordinary income and ordinary deductions.

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[13] Paul, 18 T.C. 601.

[14] 1954 IRC § 1221; 1939 IRC § 117(a)(1).

[15] This is the only case in which casualty losses are limited and are not deducted in full as ordinary deductions.

Section 1231 (1939 IRC 117(j)) therefore, would give capital gain treatment in a situation in which there existed only a gain on the involuntary conversion of a capital asset.

2. *Holding period covered.* Section 1231 (1939 IRC 117(j)) applies only to long-term items, that is, to property held over six months (twelve months for certain livestock and six years for Christmas trees). Real and depreciable property held for six months or less result in ordinary gain or loss and are excluded from computations under this section. Gains or losses from involuntary conversions of capital assets are included in the computation only if the property has been held over six months.

3. *Disposition transactions covered.* Section 1231 (1939 IRC 117(j)) covers *sales and exchanges* of real and depreciable property used in trade or business and *involuntary conversions* of both real and depreciable property used in trade or business and capital assets, and the *sale, exchange or involuntary conversion* of unharvested crops, livestock held for breeding, dairy, or draft use, the cutting or disposal of timber, and the disposal of coal. Gains or losses on the *sales or exchanges* of capital assets are not included in the computation.[16]

4. *Gains and losses covered.*

(a) Realized and recognized gains and losses.

Only gains and losses which have been realized and recognized are included in the computation.[17] This means that gains or losses postponed to another period are not used in the current period for Sec. 1231 (1939 IRC 117(j)) purposes, for example:

a. Sales not completed until another date.[18]

b. Gain on installment receivables not yet collected, when the installment sales method is used.[19]

c. Gain deferred under the deferred-payment sales method.[20]

d. Gains and losses postponed under the "tax-free" exchange rules.[21]

e. Gain deferred on involuntary conversions when the conditions for postponement are satisfied.

f. Losses on "wash sales" of stock or securities.

Losses which fall under the heading of disallowed deductions and gains which are tax-exempt also are excluded from the computations.

(b) Unlimited amount of gains and losses.

Long-term Section 1231 (1939 IRC 117(j)) gains are not subject to the 50 per cent deduction (which is provided for long-term capital gains) *before* they are taken into the computation of net Section 1231 (1939 IRC 117(j)) gain or loss; nor are the losses restricted as are capital losses. The full realized gains or losses are used. If this section applies because a net gain results, the gain is added to other long-term capital gains, and the total is subject to the 50 per cent deduction accorded an excess of net long-term capital gains. If a net result is loss, the section does not apply, and the gains and losses are treated as ordinary gains and losses, without reduction or restriction.

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[16] Sullivan, 17 T.C. 1420.

[17] Reg. 118 § 39.117(j).

[18] See discussion under Section 13 of this Chapter.

[19] *Ibid.*

[20] *Ibid.*

[21] See discussion under Section 5 of this Chapter.

5. Property covered.

(a) General.

Section 1231 (1939 IRC 117(j)) applies to:

a. Real or depreciable property used in trade or business held over six months ("Sec. 1231 (1939 IRC 117(j)) assets" discussed below).
b. Capital assets involuntarily converted.
c. A certain few special situations (discussed on page 1084).

It does not cover

a. Property used in trade or business which is not real or depreciable property (a capital asset).[22]
b. Real or depreciable property used in trade or business held six months or less (an ordinary asset).
c. Inventory or property held primarily for sale to customers in the regular course of trade or business (an ordinary asset).
d. Investments, other than rental and royalty property which rental and royalty property are real or depreciable property used in trade or business (capital asset).
e. Property held for personal use (a capital asset).
f. Copyrights; literary, musical, or artistic compositions; and similar property.

(b) Real or depreciable property used in trade or business and held over six months.

General

Of course, machinery, equipment, trucks, fixtures, buildings, and land in *use* by a business are covered. Real property which is vacant and *not used* is a capital asset and not a "Sec. 1231 (1939 IRC 117(j))" asset. Real or depreciable property which has been abandoned or which was acquired fortuitously and *never used* in the trade or business are not Sec. 1231 (1939 IRC(j)) assets. Property other than real and depreciable property are not Section 1231 (1939 IRC 117(j)) assets, except that capital assets involuntarily converted are brought into the computation. Water rights underlying land owned and used in a taxpayer's business are 1939 IRC § 117(j) assets if held over six months (Rev. Rul. 55-295, IRB 1955-20).

The transfer from a deposit liability account for returnable containers upon which no refund is to be made is not an involuntary conversion nor does it result in a gain under this section; the amount transferred is ordinary income.[23]

Depreciable property is property of a character subject to the allowance for depreciation provided in Section 167 (1939 IRC 23(1)), which states:

> A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)
> (1) of property used in the trade or business, or
> (2) of property held for the production of income.

"Depreciable property" does not cover "depletable property"; however, the point is of little importance, because depletable property is treated as real property, which also comes under Section 1231 (1939 IRC 117(j)). For treatment of amortization of emergency facilities in excess of depreciation covered in Sec. 167 (1939 IRC

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[22] However, capital assets involuntarily converted are included in the computation.
[23] *Nehi Beverage Co.*, 16 T.C. 1114 (1951).

23(1)), see discussion under "Gain Attributable to Amortization Deduction" under subsection 8(b) of this Part of this chapter.

The taxpayer should know some of the interesting applications of this provision in certain industries, such as:

a. "Dealer's cars"
b. Draft, breeding, and dairy animals
c. Rental property
d. Leaseholds, patents, copyrights, franchises, goodwill, and trade-names
e. Wasting natural resources
f. Coal royalties
g. Timber
h. Unharvested crops

"Dealer's cars"

Cars acquired by a dealer for resale but temporarily used as demonstrators are not subject to depreciation and are not Section 1231 (1939 IRC 117(j)) assets but are considered to be held primarily for sale to customers in the regular course of business and result in ordinary gain or loss.[24] However, any business, including that of a car dealer except if a demonstrator is involved, is entitled to Section 1231 (1939 IRC 117(j)) treatment for cars *used* in its business.[25] Dealer cars used for pick-up, towing, business travel, and loan to customers to replace customers' cars being serviced are all *used* in business for purposes of this section.[26] Dealer cars later sold, which were assigned to employees for their use as extra compensation, and those loaned to schools for instruction purposes are entitled to be depreciated and treated as *used* in trade or business (*Fields* v. *Granquist*, D.C. Ore., par. 72,903 P-H Fed. 1955). Such cars are subject to depreciation and should not be carried in the inventory.

Draft, breeding and dairy animals

Draft, breeding and dairy animals are used in the trade or business of farming and are covered by Section 1231 (1939 IRC 117(j)) if they are held over twelve months.[27] They are not capital assets, because depreciable property used in trade or business is specifically excluded from capital assets by the Code. Consequently, if they are not covered by Section 1231 (1939 IRC 117(j)), gain and loss from their disposition are ordinary gain and loss. Draft, breeding, and dairy animals held primarily for sale rather than use in the taxpayer's business are ordinary assets, and gain and loss thereon are ordinary. Whether the animals are held for use or primarily for sale is a point of controversy in many cases. Age of the animal, actual use in breeding, and the length of time used in breeding apparently are not material. The question is whether or not they were held for such use.

Livestock includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. Chickens, ducks, other poultry, birds, fish, and reptiles are excluded.[28]

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[24] I.T. 4062, 1951-2 C.B. 61; *Stephens Co.* v. *Comr.*, 51,231 P-H Memo, TC; (8 Cir. 1952) 199 F. 2d 665; Rev. Rul. 54-222, I.R.B. 1954-25, 5.

[25] See the discussion of rental automobiles under "Rental Property" below.

[26] *Latmer-Looney Chevrolet*, 19 T.C. 120, acq. 1953-12 C.B. 120.

[27] 1954 IRC § 1231(b); 1939 IRC § 117(j)(1).

Rental property

In general, rental property is considered to be real or depreciable property used in trade or business[29] and qualifies for treatment under this section by the landlord. Among the more interesting problems of rental property are those of cooperative apartments, converted residences, and rental versus sale-houses. Obviously, the numerous problems and rules which affect sales of real estate, in general, apply to the sales of rental real property. These matters are sketched only briefly in this chapter.

The tax court has held that the sale of old rental machines which were used in trade or business and which were replaced by new ones is the sale of property used in trade or business and not property held for sale to customers in the regular course of business.[30]

An important problem has arisen frequently in the past several years in connection with houses built for rental which have subsequently been sold. Are they held for use in trade or business or primarily for sale to customers? In one case, the taxpayer built homes under Federal Housing Administration regulations for rental to defense workers, with an option to the tenants to buy. The F.H.A. agreement permitted a certain number of units to be sold after 1943, although none was sold before 1945. The taxpayer advertised for sale and sold other homes he had built but did not advertise or solicit sales on the units in question. He kept records which were adequate to show separation of the two types of property. Although more of his income was from sales than from rental, the court held that the houses were Section 1231 (1939 IRC 117(j)) assets and the gain was not ordinary income.[31] In a similar case, the court held that the houses were held primarily for sale to customers, and the sale resulted in ordinary gain. The principal difference between the two cases was in the amount of effort the taxpayer made to find customers. In the latter case, the taxpayer made strenuous efforts to sell.[32]

In several recent cases, the sale of war houses after Government restrictions were removed resulted in ordinary gain.[33] Property held for rental or for sale, whichever is more profitable, is held primarily for sale to customers and results in ordinary gain or loss.[34]

In another interesting case, the taxpayer won the decision on one rental unit sold and lost the decision on some others. The corporation was in the business of renting houses. In 1945, it made an isolated sale of one house. In 1946, it was decided to dispose of all single-family units, and the corporation sold 42 of 212 units. The Tax Court held the sale in 1945 resulted in Section 1231 (1939 IRC 117(j)) gain and the sales in 1946, in ordinary income.[35] The 1945 sale was the sale of an asset used in trade or business; according to the Tax Court, the 1946 sales were of property held for sale to customers. However, the Tax Court decision on the 1946 sales was reversed by the Tenth Circuit Court.[36]

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[28] Reg. 118, § 39.117(j)-2.

[29] See discussion under Section 4 of this Chapter.

[30] *A. Benetti Novelty Co., Inc.*, 13 T.C. 1072.

[31] *Delsing* (5 Cir. 1951), 186 F. 2d 59, 40 AFTR 25.

[32] *King* v. *Comr.* (5 Cir. 1951), 189 F. 2d 122, 40 AFTR 665, cert. den. 10/8/51.

[33] *Dougherty*, 53,132 P-H Memo TC (1953).

[34] *Rollingwood Corp.* v. *Comr.*; *Bohannon* v. *Comr.* (9 Cir. 1951), 190 F. 2d 263, 40 AFTR 1006.

[35] *Victory Housing No. 2, Inc.*, 18 T.C. 466.

The frequency and continuity of sales are important factors. Houses built for sale, then repossessed, then rented for several years, and then sold through a broker were considered to have been held for sale to customers in the regular course of business.[37] Placing a restriction on sales, by giving the tenant the first option to buy or by making sales subject to the tenant's rights may be sufficient to secure favorable capital gain treatment for the property.[38]

Under some circumstances, an unsuccessful attempt at rental is sufficient to obtain Section 1231 (1939 IRC 117(j)) treatment. This was so in the case of an inherited residence which was sold after unsuccessful efforts were made to rent it out.[39]

Sometimes gain or loss on the sale of property is partly personal and partly covered by Section 1231 (1939 IRC 117(j)), for example, in the case of a summer home used in part for pleasure and in part for the entertainment of customers. A gain would be partially capital gain (pleasure) and partly Section 1231 (1939 IRC 117(j)) (business); a loss would be partly nondeductible (personal) and partly Section 1231 (1939 IRC 117(j)).[40] A taxpayer who purchased and lived in a cooperative apartment in a building which was 30 per cent occupied by non-owner tenants was adjudged to have a personal loss on the sale of his interest, to the extent of 70 per cent and a Section 1231 (1939 IRC 117(j)) loss to the extent of 30 per cent.[41] This was true, although he had subleased the apartment before selling it.

The Service has ruled [42] that rental automobiles are held for both rental and resale as used automobiles and that ordinary gain or loss results from their sale, in spite of the fact that they are depreciable property used in trade or business and appear to be entitled to special treatment if held over six months.[43] This ruling is inconsistent with the Tax Court decision in the *Benetti* case.[44] Depreciation is allowed on leased automobiles prior to their conversion to property held for sale to customers, although not on demonstrators.

The matter may be briefed in this way:

Type of Asset and Purpose for Holding	*Treatment*
a. Real estate held by a dealer for sale to customers in the ordinary course of business.	Ordinary gain or loss
b. Unrented vacant real estate held for investment	Capital gain or loss
c. Residence held for personal use	Capital gain or nondeductible loss
d. Real or depreciable property used in trade or business, held over six months	Section 1231 (1939 IRC 117(j)) gain or loss

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[36] *Victory Housing No. 2, Inc.* v. *Comr.* (10 Cir. 1953), 205 F. 2d 371, reversing 18 T.C. 466.

[37] *Blake, et al.* v. *Kavanagh*, D.C., E.D. Mich., S.Div., 1952, 107 F. Supp. 179.

[38] *Elgin*, par. 49,015 P-H Memo TC (1949).

[39] *Crawford*, 16 T.C. 678.

[40] *Kraft*, par. 49,159 P-H Memo TC (1949).

[41] *Calder*, 16 T.C. 144, acq. 1951-1 C.B. 1.

[42] Rev. Rul. 108, 1953-13 C.B.

[43] See the discussion of dealers' cars above.

[44] See footnote 30.

Type of Asset and Purpose for Holding	*Treatment*
e. Real or depreciable property used in trade or business, held six months or less	Ordinary gain or loss
f. Residential property converted to the production of income, held over six months	Section 1231 (1939 IRC 117(j)) gain or loss[45]
g. Residential property converted to the production of income, held six months or less	Ordinary gain or loss[46]

Leaseholds, patents, copyrights, franchises, good-will, and trade-names

Only real property and depreciable property are Section 1231 (1939 IRC 117(j)) assets. Intangibles subject to depreciation come within this area if they are used in trade or business. Goodwill and trade-names seldom are depreciable and, therefore, almost never qualify. Patents, leaseholds, franchises, and copyrights may be subject to depreciation and come under this section. Copyrights and similar property in the hands of the creators or a person who derives his basis from the creator are neither capital assets nor Section 1231 (1939 IRC 117(j)) assets; they are ordinary.[47] Patents sold by an inventor are capital assets.

Depletable wasting assets

Oil, gas, and mineral properties and oil, gas, and mineral lease interests of a lessee are "real property" and come under this section if they are held over six months and are used in trade or business.[48] Under certain circumstances, such properties may be capital assets in the nature of investments,[49] or ordinary assets if held for sale to customers in the regular course of business.[50] Unmined coal is real property and is not property held for sale to customers until it is extracted for that purpose.[51] Income derived from oil, mineral, and gas leases is ordinary income and is not gain from the sale of real property.[52] However, this section may apply to coal and timber royalties under some circumstances.[53]

c. Certain special coverage provided.

In addition to giving special advantageous treatment to real and depreciable property held over six months for use in trade or business, this section provides that certain incomes, which have the same general characteristics usually associated with ordinary income, shall be brought into the Section 1231 (1939 IRC 117(j)) computation as gains. This unusual advantage is given to unharvested crops, coal royalties, and timber cutting and royalties.

Coal royalties

Section 631(c) (1939 IRC 117(k)(2)) extends Section 1231 (1939 IRC 117(j)) coverage to include coal royalties received by a lessor. The privilege is not given to operators, however, even those operating through a partnership or joint venture. The difference between the royalties received and the basis of the coal disposed of is Section 1231(1939 IRC 117(j)) gain or loss. Percentage depletion may not be deducted by a taxpayer who takes advantage of this section; only cost depletion may be used in figuring tax. The coal must have been owned over six months before it is mined; the date of the contract is not important. This provision affects only the recipient of the income; it does not prevent the payor from taking an ordinary deduction for royalty expense.[54] Section 531 (1939 IRC § 102) surtax on improper accumulations of income by corporations and the personal holding company surtax are not affected by this provision.

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[45] Residential property so converted is "used in trade or business."

[46] Excluded from Sec. 1231 (1939 IRC § 117(j)) because not held over six months; excluded from capital assets because the Code excludes real and depreciable assets used in trade or business from capital assets.

[47] 1954 IRC § 1221 and 1231; 1939 IRC § 117(a)(1) and 117(j)(1).

[48] I.T. 3693, 1944 C.B. 272.

[49] *Foran* v. *Comr.* (5 Cir.), 165 F. 2d 705, 36 AFTR 698, reversing par. 46,228 P-H Memo TC.

[50] *Gutowsky* v. *Jones* (D.C. Okla., 1951), 100 F. Supp. 852.

[51] *Butler Consolidated Coal Co.*, 6 T.C. 183.

[52] *Berg.* v. *Comr.* (CADC), 33 F. 2d 641, 7 AFTR 9195. Dec. 1929 C.B. 280, cert. denied.

[53] See discussion under "Coal Royalties" and "Timber Royalties" below

Timber royalties and cut timber[55]

The proceeds from royalties or timber cut for sale or use in the taxpayer's business is covered by Section 1231 (1939 IRC 117(j)) in about the same manner as coal royalties.[56] There are some important differences, however. Unlike the case of coal, operators, lessors, and lessees may all avail themselves of this part of the law. Standing or cut timber held for six months or less results in ordinary gain or loss. The sale of standing timber held over six months results in Section 1231 (1939 IRC 117(j)) gain or loss. Timber held over six months, (a) before the start of the taxable year if it is cut by the owner or one who has a contract right to cut it or (b) before it is cut if it is cut by the lessee, may be treated as a Section 1231 (1939 IRC 117(j)) asset. If the taxpayer cuts his own timber, gain or loss is the difference between its basis for depletion and the fair market value on the first day of the cutting year. That fair market value then becomes the basis of the timber for future sales. The use of this provision (Section 631(a) (1939 IRC 117(k)(1)) is at the election of the taxpayer and if chosen is binding in future years and for other timber. In the case of royalties from a lessee, gain or loss is the difference between the amounts received and the basis for depletion. The treatment of royalties is substantially the same as that given coal royalties; both are covered by Section 631 (1939 IRC 117(k)(2)). The taxpayer must use Section 1231 (1939 IRC 117(j)) if it applies under Section 631(b)(c) (1939 IRC 117(k)(2)); he has no election, as he does under Section 631(a) (1939 IRC 117(k)(1)). "Timber" includes evergreens (Christmas trees) held over six months when cut and sold for ornamental purposes.

Unharvested crops

A sale or exchange or conversion of land used for farming and the sale of an unharvested crop thereon made at the same time and to the same buyer result in gain or loss under this section if the land is Section 1231 (1939 IRC 117(j)) property and was held over six months.[57] The seller must retain no right or option at the time of sale, exchange, or conversion to reacquire the land, other than one incident to mortgage or other security agreement. A leasehold or estate for years is not

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[54] 1954 IRC § 631(c); 1939 IRC § 117(k)(2).

[55] For a more complete discussion of the income tax problems of timber, see: *The Small Timber Owner and His Federal Income Tax,* Agricultural Handbook No. 52, U.S. Dept. of Agriculture, Forest Service, Washington, 1953, 55 pages.

[56] 1954 IRC § 631; 1939 IRC § 117(k); Reg. 118, § 39.117(k)-1.

[57] 1954 IRC § 1231(b); 1939 IRC § 117(j)(3).

"land" for the purposes of this section. This rule applies to involuntary conversions as well as to sales. The result is capital gain treatment for a net gain or ordinary loss for a net loss. Costs of producing the crop are part of basis in figuring gain or loss and are not ordinary expense deductions.[58]

6. *Illustration of the operation of section 1231 (1939 IRC 117(j)).*[59]

Example 1:

A, an individual, makes his income tax return on the calendar year basis. A's recognized gains and losses of the kind described in this section are, as follows:

	Gains	*Losses*
1. Gain on sale of machinery, used in trade or business and subject to an allowance for depreciation, held over six months (Sec. 1231 (1939 IRC 117 (j)) asset—sale or exchange)	$ 4,000	
2. Gain reported in current year (under Sec. 453 (1939 IRC § 44)) on installment sale in a prior year of factory premises used in the business, including building and land, each held for over six months. (Sec. 1231 (1939 IRC 117 (j)) assets—sale or exchange)	6,100	
3. Gain reported in current year (under Sec. 453 (1939 IRC § 44)) on installment sale in current year of land held for over six months, used in the business as a storage lot for trucks (Sec. 1231 (1939 IRC 117 (j)) asset—sale or exchange)	1,500	
4. Gain on proceeds from requisition by Government of boat, held more than six months, used in the business, subject to depreciation. (Sec. 1231 (1939 IRC 117(j)) asset—involuntary conversion)	400	
5. Loss upon the destruction by fire of a warehouse, held over six months, used in the business (Sec. 1231 (1939 IRC 117(j)) asset—involuntary conversion)		$3,000
6. Loss upon theft of unregistered bearer bonds, held over six months. (Capital asset—involuntary conversion)		5,000
7. Loss in storm of pleasure yacht, purchased in 1940 for $1,800 and having a fair market value of $1,000 when lost. (Capital asset—involuntary conversion—casualty loss)		1,000
8. Loss on requisition of pleasure yacht by Government (or loss on sale) in the amount of $10,000. (Capital asset—sale or exchange—nondeductible personal loss)		—
9. Sale of depreciable property, held over six months, used in trade or business, sold to spouse, at a gain of $5,000 (Sec. 1231 (1939 IRC 117		

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[58] 1954 IRC § 1016; 1939 IRC §§ 113(b)(1)(L), 24(f); Reg. 118, § 39.24(f)-1, § 39.117(j).

[59] These examples are based upon those furnished in Reg. 118, Sec. 29.117(j).

	Gains		Losses
(j)) asset—sale or exchange—ordinary gain under Sec. 1239 (1939 IRC 117(o))[60]	—		
10. Gain on the sale of depreciable property, used in business, held over six months, subject to emergency amortization, gain if ordinary depreciation were used $500; gain after use of emergency amortization $3,500. ($3,000 as ordinary income under Sec. 1238 (1939 IRC 117(g)(3)); the balance is Sec. 1231 (1939 IRC 117 (j)) gain.)[61]	500		
11. Total gains and losses	$12,500		$9,000
12. Excess of gains over losses		$3,500	

Since the aggregate of the respective recognized gains ($12,500) exceeds the aggregate of such recognized losses ($9,000), such gains and losses are treated under Sec. 1231 (1939 IRC 117(j)) as long-term capital gains and losses. Such items are treated the same as any other long-term gains and losses and will cause the inclusion of $3,500 in computing his net long-term capital gain for purposes of the regular and alternative taxes.

Example 2:

If in Example 1 the taxpayer were a corporation, these items (except, of course, property held for personal use) will cause $3,500 (item 12) to be included in net long-term capital gain just as for noncorporate taxpayers.

Example 3:

If in Example 1, A also had a loss of $4,000 from the sale under threat of condemnation of a capital asset (not held for personal use), held for over six months, then the gains ($12,500) would not exceed the losses ($9,000 plus $4,000). Neither the losses nor the gains listed in Example 1 would then be treated as capital gains and losses, but all of such items would be treated as ordinary gains and losses. Since all of such items are included in full in computing net income, the net effect of such items will be the inclusion in computing net income of a loss of $500 (the excess of the $13,000 losses over the $12,500 gains). This same result would follow for a corporation.

Example 4:

If the loss in Example 3 were $3,500 (instead of $4,000), there would be no net gain nor net loss, but the gains and losses would still be treated as ordinary gains and losses and not as capital gains and losses, since the gains do not exceed the losses.

An individual's gain on a Section 1231 (1939 IRC 117(j)) asset may *not* be offset by his share of his partnership's losses on such assets (*Ammann*, 22 T.C. 1106), and his losses may not be offset by his share of his partnership gains (*Paley*, 22 T.C. 1236). The Internal Revenue Service has appealed both cases to the Circuit Courts.

7. *Treatment of Section 1231 (1939 IRC 117(j)) gains and losses in tax returns.* If the net result is an excess of Section 1231 (1939 IRC 117(j)) gains over Section 1231 (1939 IRC 117(j)) losses, the gains and losses are treated as capital gains and losses and are so entered on the tax forms. If the net result is an excess of such losses over such gains, the losses and gains are treated as ordinary items and are re-

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[60] See subsection 8(a) of this part of this chapter.

[61] See subsection 8(b) of this part of this chapter.

ported in the portion of the schedule devoted to gains and losses on sales and exchanges of property other than capital assets.

8. *Loophole-plugging.* The Code contains two provisions which restrict the advantages the taxpayer may enjoy under this section. Both require a gain to be treated as ordinary income. Both relate to depreciable property and the desirability of treating both depreciation and gains on the disposition of the property in the same way, as ordinary items.

(a) Gains on sales of depreciable property directly or indirectly between spouses and between an individual and his controlled corporation.

If the property is subject to depreciation in the hands of the transferee—an individual, a spouse, or a controlled corporation—the gain of the transferor is ordinary gain and not Section 1231 (1939 IRC 117(j)) or capital gain.[62] This provision covers transfers both to and by a controlled corporation. A controlled corporation is one in which over 80 per cent of the value of outstanding stock is owned by the taxpayer, his spouse, minor children, and minor grandchildren, including adopted and step children and grandchildren. This rule prevents the transferee from getting a stepped-up basis for the property for depreciation, while the transferor includes less than the stepped-up basis as taxable gain.

For example: assume that one party owns a building with an adjusted basis of $10,000 and estimated remaining life of 5 years, and that the building is sold for $15,000 to a spouse or controlled corporation (or by a controlled corporation to the controlling individual). Without this portion of the law, the seller would have a capital gain (Section 1231 (1939 IRC 117(j)), one-half of which (after the 50 per cent deduction of the excess of net long-term capital gain over net short-term capital loss allowed a noncorporate taxpayer) would be subject to a maximum tax rate of 50 per cent. The maximum tax would be $1,250 ($5000 × 50 per cent × 50 per cent), while the buyer would have property with a basis for depreciation stepped-up in the amount of $5,000. This stepped-up basis would reduce the recipient's ordinary income in the future through depreciation to the extent of $5,000, which amount would otherwise have been subject to ordinary tax rates. The Code simply provides that the seller has ordinary income of $5,000 on the transfer. The nature of this restriction is such that it can be avoided very easily by using a transferee not named in this provision or by reducing the percentage of stock held to, say, 79 per cent.

This provision covers property subject to depreciation under Section 167 (1939 IRC 23(1)) and amortization under Sections 168 and 169 (1939 IRC 124A, 124B, and 23(t)), but it does not cover property subject to depletion. Intangibles (as well as tangible property) such as leases, franchises, licenses, etc. are covered if they are depreciable. This provision applies to all depreciable property, not only that which qualifies as Section 1231 (1939 IRC 117(j)) property.[63] It does not apply to land; consequently, if business land and a building are so transferred, the gain on the land is Section 1231 (1939 IRC 117(j)) gain and that on the building is ordinary gain.

(b) Gain attributable to amortization deduction

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[62] 1954 IRC § 1239; 1939 IRC § 117(o); Reg. 118, § 39.117(o)-1.

[63] See the discussion under "Property Covered" in Section 7 of this Chapter.

Section 1238 (1939 IRC 117(g)(3)) provides that gain on the sale of property subject to amortization for emergency facilities under Section 168 (1939 IRC 124A) is ordinary income to the extent the adjusted basis of the property is less because of the excess of emergency amortization over ordinary depreciation. For example:

	If Taxpayer Used: Ordinary Depreciation	If Taxpayer Used: Emergency Amortization
Cost of property	$10,000	$10,000
Amortization-depreciation	1,000	4,000
Adjusted basis	$ 9,000	$ 6,000
Sale Price	9,500	9,500
Total gain	$ 500	$ 3,500
Subject to Section 1231 (1939 IRC 117(j))		500
Ordinary income		$ 3,000

Or to state it differently, the gain is $3,500, $3,000 ($9,000 – $6,000) of which is due to emergency amortization greater than normal depreciation and is treated as ordinary income, the balance being Section 1231 (1939 IRC 117(j)) gain.[64]

This provision applies also to property received in an exchange if it has the same basis as the property given which was subject to emergency amortization or the same basis as in the hands of a transferor from whom it was received and who used emergency amortization.

8. Rules for Losses

a. General. Ordinary losses are deductible in full from taxable income. Capital losses are divided into two categories, long-term and short-term. However, both are taken into the computations to the same degree, except to the extent long-term losses are used to offset long-term gains. A net capital loss, after losses have offset capital gains, is not deductible by a corporation and is deductible to a limited degree of $1,000 or less by a noncorporate taxpayer.

Section 1231 (1939 IRC 117(j)) losses are offset against Section 1231 (1939 IRC 117(j)) gains. A net gain is treated as a long-term capital gain, but a net loss results in treating the gains and losses as ordinary gains and losses. The treatment of a net loss under this section may be illustrated thus:

Long-term capital gain from sales	$20,000
Long-term capital loss from sales	10,000
Excess of net long-term capital gains	$10,000
Deduction of 50 per cent Sec. 1202 (1939 IRC 117(b))	5,000
Net capital gain subject to tax	$ 5,000
Section 1231 (1939 IRC 117(j)) net loss—ordinary loss	3,000
Net taxable income	$ 2,000

Ordinary losses, including the Section 1231 (1939 IRC 117(j)) net loss, do not enter into the computation of the 50 per cent deduction, even if the Section 1231 (1939 IRC 117(j)) net loss was from the *involuntary conversion* of a *capital asset.*[65]

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[64] Reg. 118, Sec. 39.117(g)-2.

[65] *Sullivan*, 17 T.C. 1420.

Only the losses from *sales* of *capital assets* are so used. An incorrect solution for the foregoing assumed situation would be:

Long-term capital gain from sales		$20,000
Long-term capital loss from sales	$10,000	
Section 1231 (1939 IRC 117(j)) net loss	3,000	13,000
Balance		$ 7,000
Less 50 per cent deduction		3,500
Net taxable income		$ 3,500

b. Averaging of losses of sales of business property under IRC Section 172. IRC Section 172 (1939 IRC 122) provides for the carry back for two years and carry forward for five years of a net operating loss deduction. The purpose is to permit a business with fluctuating net income and loss to average out and to reduce the aggregate tax burden down to that which a taxpayer with a more level income history would have. The net operating loss deduction, however, is not necessarily the loss which results from subtracting allowable deductions from taxable income, since it is subject to certain adjustments and limitations. Deductions not attributable to the operation of a noncorporate taxpayer's trade or business are allowed only to the extent of taxable income not derived from trade or business.[66] Losses on liquidations of property of a business (a going business or a liquidating business)[67] may be carried forward and backward under Section 172.

II

HOW TO USE THE RULES FOR SALES OR EXCHANGES OF PROPERTY TO MINIMIZE TAXES

Obviously, it is necessary to minimize taxes on a disposition of property in order to get the best net price and the greatest benefit from the disposition. After all, the price *after taxes* is the important amount.

The taxpayer should:

	Section
Sell to the purchaser with whom the best agreement can be reached	9
Select carefully the property to be sold	10
Allocate wisely the sales price of a group-sale of assets to the separate parcels	11
Decide how best to dispose of the property	12
Time (i.e., realize) the gains and losses to give the best net result	13
Know who should make the sale when related parties are involved	14
Avoid tax traps	15
Consider the alternative to taxable sales and exchanges	16

Translation of a desired course of action into suitable and adequate sales contracts and other legal instruments requires careful and painstaking work if the desired results are to be obtained and undesirable consequences avoided. Help can be secured from several books published on the subject of legal forms.[68]

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[66] 1954 IRC § 172; 1939 IRC § 122(d)(5).

[67] 1954 IRC § 172.

9. Select the Purchaser Carefully

Obviously, of course, look for the buyer who will pay the highest price, but also find the buyer who will enter into an agreement favorable to you, the seller. Find one who will agree to do some of these things: (a) buy on the installment basis, (b) pay a contingent price, (c) buy on the deferred payment plan, (d) enter into a sale when it is most advantageous for you, (e) apportion the consideration in purchases of a group of assets in an agreeable manner.

10. Select the Property to Be Sold

Take advantage of the definition of capital assets to get long-term capital gains and ordinary losses. Long-term capital gains are taxed at a maximum rate of 25 per cent; ordinary losses may be deducted without restriction. A taxpayer may hold a certain type of property as an ordinary asset, a capital asset, and a real or depreciable asset used in trade or business. Since the tax consequences of a sale of one type may differ from that of a sale of another, it is essential that the taxpayer keep records adequate to show segregation and provide suitable identification of the property sold.

Sometimes the taxpayer can follow a course of action which results in a change in the classification of a piece of property. For example, a loss on the sale of a residence is nondeductible but if it is rented out before sale, the loss is deductible. A machine constructed for sale in the ordinary course of business but *used* in the business instead of being sold is a Section 1231 (1939 IRC 117 (j)) asset rather than an ordinary asset; the gain may be treated as capital gain rather than ordinary gain. Property acquired primarily for resale to customers in the ordinary course of trade or business can be converted to *use* in trade or business, with the result that a loss on disposition of such assets may come under Section 1231 (1939 IRC 117(j)).[69]

Consider the sale of a partnership interest, since under most circumstances, a gain is a capital gain. A sale of partnership property might result in capital gain, but it might also result, at least in part, in ordinary gain, depending upon the types of assets sold.

However, the sale of a proprietorship is deemed to be a sale of the underlying property, some parts of which are and some of which are not capital assets. It is possible, though, to transfer the property in a tax-free exchange for corporation shares and then to sell the shares at a *capital* gain.

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[68] For example: J. Rabkin and N. H. Johnson, *Current Legal Forms,* Vol 2, Albany, N. Y., Matthew Bender & Co., 1949, Chap. 4 and 5, pp. 1-615.

[69] *Good,* 16 T.C. 906.

11. Allocate Sales Price Intelligently on a Group-sale of Assets

In purchases and sales of a group of assets care must be used by the taxpayer to get the other party to agree to the most advantageous allocation of sales price, since the sales price affects the gain of the seller and the basis of the property in the hands of the buyer. Obviously, their interests may conflict, and a suitable compromise must be made or another party found for the transaction. Generally, the allocations by the parties are usable for tax purposes; however, completely unrealistic amounts will not stand up.

A *seller* who has a *gain* should allocate high for capital assets (lease, goodwill, trade-names, etc.) and low for ordinary assets (inventory, covenant not to compete, etc.); if he has a loss he should allocate in the opposite direction. Allocations to Section 1231 (1939 IRC 117(j)) property should be high since net gains are treated as capital gains and net losses as ordinary losses.

12. Decide How to Dispose of Property to Take Advantage of the Definition of Sales and Exchanges

Capital gains and losses result only if capital assets are sold or exchanged (and also from involuntary conversions if Section 1231 (1939 IRC 117(j)) applies); consequently, a sale or exchange may be arranged under some circumstances if *capital* gain is desired, or avoided if *ordinary* loss is wanted.

For example: sales or gifts and lease-back arrangements have been used frequently in sales to tax-exempt organizations and between closely held corporations and a dominant shareholder or shareholders. The usual arrangement is for the seller to take back a long-term lease on the property sold or given, the rentals being applied against the sales price. The advantages to the seller are: (a) a rental deduction in lieu of a more controversial depreciation deduction, (b) perhaps, a rental amount in excess of allowable depreciation, (c) a rental deduction for land which may not be depreciated, (d) the lease can require the seller (i.e., the tenant) to pay taxes and operation and maintenance costs of the property, with resulting tax deductions for the seller, and (e) ready cash may be made available to the seller upon the sale.

There are some income tax dangers and uncertainties in lease-back situations, and in particular instances they may not stand up under attack by the Treasury. For example, if lease payments will equal the sale price of the property while it still has substantial use life left, the lease may be considered a sale rather than rental. Under some circumstances the Treasury may contend a tax-free exchange exists.[70]

13. Time Gains and Losses From Sales or Exchanges Most Advantageously

Tax minimization can be accomplished in large measure through the proper timing of gains or losses. Gains can be deferred and losses speeded up in anticipation of a period of lower taxes or decreased total income; or gains hastened and losses delayed if higher taxes and larger total income are forecast. Sometimes the taxpayer secures an advantage in offsetting gains against losses or vice versa; in other cases he should try to space gains and losses so they do not offset each other.

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[70] A good discussion of leasebacks is: William L. Cary, "Current Problems in Sales or Gift and Lease-back Transactions," *Taxes,* August, 1951. Vol. 29, p. 662.

To take advantage of the rules for timing, the taxpayer should:

a. Know when a sale is completed
b. Consider the use of installment sales
c. Consider the use of contingent-price sales
d. Consider the use of deferred payment sales
e. Consider the use of "tax-free" exchanges
f. Use IRC Sec. 1231 (1939 IRC 117(j)) to the most advantage
g. Make the best use of the holding period rules
h. Make good use of the capital loss carryover rules
i. Use IRC 1302 (1939 IRC Sec. 107 (b)) to spread gain from artistic and inventive creations
j. Consider the postponement of gain on involuntary conversions.

a. Know when a sale is completed. The closing of a sale can be put off to a later period by delaying the passage of title or by taking proceeds which have no fairly ascertainable market value. It has been held that ascertainable value is lacking and income realization is postponed if collections are contingent upon the happening of some future event or the removal of some impediment. However, if the seller receives the proceeds, without restriction, with the agreement to return some or all of it if certain things happen or fail to happen, he has income at the time of receipt, subject to later adjustment. Guarantee agreements may result in postponed income only if the amount of the guarantee is subject to substantial restriction and is not received by and under the free control of the seller. The seller has income in full if he receives the proceeds subject to the return of part if the guarantee must be made good.

Contracts may be executory, to be completed in a later year when title and possession are transferred; sales of real estate usually are completed on the day of settlement.

Options and lease-options are not sales although they may be followed by sales; forfeited option receipts are income when forfeited; they are applied to the sales price if and when the option is exercised. Options and lease-options which are disguised sales will not be upheld if they are mere form without substance.

Title does not pass if the parties do not intend it to pass; a contract of sale is not a completed sale without passage of title. Intent of the parties is determined by the terms of the contract, the conduct of the parties, the customs of the trade, and other circumstances present in a given situation. Unless the intent is to the contrary, title passes when an unconditional contract is made for goods in a deliverable condition; if they are not in a deliverable state, title passes when they are put into such condition. Title passes to a portion of fungible goods when the sales contract is executed. Ownership of specific goods passes when severance occurs. Property in future or unascertained goods passes after they come into being, are placed in a deliverable condition, and are appropriated to the contract. In the absence of a material contingency, sale income is accruable when title passes.

Approval sales, consignment sales, agency sales, C.O.D. sales, sales where goods are returned because incorrect or defective, etc. are not complete at the time of the sales contract. The sale is not delayed by guarantees, warranties, agreements to repurchase, later rejection by purchaser, later determination of price, property being in transit to buyer where title has passed to buyer, where the seller stores the property for the buyer; or where title is retained (as in some installment sales) for security.

This whole area of the timing of sales is part of a large problem which cannot be treated adequately in this chapter.

b. Consider the use of installment sales. This method is applicable to (1) dealers in personal property who regularly sell on the installment plan, (2) casual sales of personal property over $1,000 (which includes machinery, equipment, investments, etc.) and (3) casual and dealer sales of real estate (which includes land, buildings, etc.). The installment sales method permits the spreading of income over the period of collection rather than the inclusion of all of it at once at the time of sale. The installment sales method may be used for such cases regardless of how the books are kept for other purposes; it may be used for casual sales of personal property and any sales of real estate provided the payments in the year of sale do not exceed 30 per cent of the sales price; however, sales by dealers in personal property are not subject to such limitation. The advantages and disadvantages of this method and other important details are discussed at some length elsewhere in this book.

c. Consider the use of contingent-price sales. The disposition price of the property can be made dependent upon future sales, future production, future extraction of natural resources, etc. The full sales price is not known at the time of sale, because it continues to grow as contingent events happen. This type of sale price is a good hedge against inflation if the contingent price is set as a percentage of dollar sales, dollar profit, etc. Income is reported only after cost has been recovered. First collections are recoveries of cost; later collections are wholly income. This method has about the same advantage of spreading that is furnished by the installment sales method; however, it has some advantages over installment sales, namely: (a) it permits a longer postponement of gain, since earliest collections are all cost recovery and not taxable gain in part, and (b) installment sales of real property and casual installment sales of personal property must meet certain requirements as to the amount of collections in the year of sale; contingent price sales are not subject to such restrictions.

The seller may secure some advantage in sales with future conditional payments if such payments are all part of sales price and not interest in part, since sales price can give capital gain, while interest is ordinary income.

Although contingent-price sales are more flexible than installment sales, they are somewhat more risky since the price is a contingent one.

d. Consider the use of a deferred-payment sale. The effect is somewhat similar to that of a contingent-price sale. Gain is taxed in the year of sale to the extent of the excess, if any, of the cash and the fair market value of property or the buyer's obligations received over the basis of the property sold. Taxable gain is not reported until cost (basis) is recovered. In all probability a mere promise to pay, non-negotiable notes, and escrowed property have no fair market value for this computation.

e. Consider "tax-free" exchanges. Sales and exchanges usually result in the realization of gain or loss; such realization can be postponed, however, through the use of certain kinds of exchanges, which are commonly called "tax-free" exchanges. As a matter of fact, they are not "tax-free"; they are merely postponed.

For example, exchanges of property held for productive use in trade or business apply to the common business situation of the trade-in of equipment, machines, trucks, etc. The taxpayer can realize gain or loss at once by sale, or postpone either by this type of "tax-free" trade-in. He has his option of trading an old for a new asset or of selling the old and purchasing the new.[71]

f. Use section 1231 (1939 IRC 117(j)) to the most advantage. Real and depreciable property held over six months can be sold most advantageously if the gains are taken in one year and losses in another. For example:

	All Sales In One Year	Gains and Losses in Different Years	
		Gain Year	*Loss Year*
Machine #1—gain	$1,000	$1,000	
Machine #2—loss	(1,000)		$1,000
50 per cent of Excess of Net Long-Term Capital Gain Over Net Short-Capital Loss is deductible		(500)	
Gain Taxable—Loss Deductible	$ 0	$ 500	($1,000)
Net deduction for two years		$(500)	

Proper spacing permits (a) cutting the gain in half and taxing that half at 50 per cent—a maximum tax of 25 per cent or $250 on the $1,000 gain and (b) the deduction of the full loss of $1,000 in another year. Assuming the taxpayer is in the 60 per cent bracket, he pays the $250 tax in one year and saves $600 ($1,000 loss at 60 per cent) in the next, a net saving of $350 over the situation in which gains and losses are allowed to offset each other in the same year.

The same plan of separation should be followed if the taxpayer has had an asset destroyed or damaged; he should postpone Section 1231 (1939 IRC 117(j)) gains on a gain sale of other property until a later year if possible, to get the benefit of the full loss deduction in one year and the treatment of the gain as capital gain in another year and to avoid offsetting one against the other.

Since Section 1231 (1939 IRC 117(j)) may be applied to the cutting of timber (a) to give capital gain on the increase in value and (b) to give the cut timber a basis for future sale, equivalent to the fair market value when the timber is cut, the taxpayer may be able to reduce taxes in a period of rising prices by setting a high market value on the cut timber to increase capital gain on cutting and to reduce subsequent ordinary income on the sale of the timber.

g. Make the best use of the holding period rules. The taxpayer sometimes can take advantage of capital gain rules by selling property at a loss for a short-term loss, or at a gain for a long-term gain by observing the six months dividing line. He can have losses on sales of real and depreciable property used in trade or business classified as ordinary loss and gains as capital gains if he sells loss property held no more than six months and gain property held over six months.

h. Make good use of the capital loss carryover rules. Net capital losses may be carried over and applied against capital gains or ordinary income to a limited extent for five years. Gains and losses should be timed to avoid the loss of any benefits furnished by the carryover provisions. For example, if the taxpayer has a 1954 loss and a large 1953 tax, he should consider not selling property at a gain in 1954 to offset the loss, because the 1954 loss can provide him with a large refund for 1953. If in a given year a capital loss has been carried over for five years and is about to expire, the taxpayer should sell property at a gain in order to have something against which to apply and use his carryover rather than have it lapse.

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[71] The subject of tax-free exchanges is complex. It is explained briefly in Section 5 of this Chapter.

i. Use Section 1302 (1939 IRC 107(b)) to spread gain from artistic and inventive creations. Patents under some circumstances may be given capital asset or Section 1231 (1939 IRC 117(j)) treatment; copyrights may not. However, both are covered by Section 1302 (1939 IRC 107(b)), which permits "lumped" income to be spread over a limited period of months, if the period of work on the property was 24 months or more and at least 80 per cent of the aggregate income from the property for previous years, the current year, and the next year is received or accrued in the current year.

j. Consider postponing gain on involuntary conversion. Involuntary conversion includes condemnation, destruction, and thefts. Losses on involuntary conversion of business property are fully deductible, although the effect of the deduction might be weakened if Section 1231 (1939 IRC 117(j)) applies.[72]

Tax on a gain may be postponed if the converted property is replaced by a suitable piece of property and within a certain limited period of time before or after the disposition of the property.

14. Decide Who Should Make the Sale—The Corporation or the Shareholders

If property is sold at a gain by a corporation and the proceeds are distributed to the (noncorporate) shareholders as a cash dividend of earnings or as a liquidating distribution in cash,[73] more aggregate tax will be paid by both than if the property is distributed in kind and the shareholders sell it. A sale causes gain to be realized; a distribution does not. To illustrate:

Sale by Corporation	*Corporation*	*Shareholders*	*Both*
Sale price	$10,000		
Cost	(4,000)		
Distribution of cash		$10,000	
Gain	$ 6,000	$10,000	$16,000
Sale by Shareholders			
Distribution in kind		$10,000	
Sale price		10,000	
Basis-Fair Value When Received		(10,000)	
Gain	$ 0	$10,000	$10,000

In both cases the shareholders have $10,000 of taxable income (cash dividend or fair-market value of property dividend); the saving is that of the corporation.

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[72] See Section 7 of this Chapter.

[73] However, 1954 IRC Sec. 337 provides that under some circumstances income will **not** be taxable to the corporation.

In the case of property which has decreased in value, it is more advantageous for the corporation to sell and distribute the proceeds. Again, the shareholders are in the same position whether they or the corporation sells; it is the corporation which benefits. Of course, the shareholders benefit indirectly if their corporation saves taxes.

There are some pitfalls in cases of this sort; favorable results depend on the finesse of the tax-planner. Controlling shareholders may find that a sale of their shares rather than a sale of corporation property and dissolution of the corporation suits their purpose better.

15. Avoid Tax Traps

The following provisions are traps to the unwary taxpayer but are relatively easy to avoid.

Sales of property at a loss (even if bona fide sales) between closely related persons result in a permanent disallowance of the loss in the transferor's returns. A loss on a sale to a son would be disallowed; it would be allowed for example, if made to the son's wife.

Money can be taken out of a corporation as a capital gain by a taxpayer who owns stock in two or more corporations—even if he controls both—by having one corporation purchase from him the shares of another corporation, except if parent stock is sold to a subsidiary by the parent's shareholders.[74]

Losses on "wash sales" of stock or securities are not deductible in the year of sale but are postponed until some future time when the reacquired securities are sold. This provision can be avoided by placing the reacquisition of identical securities outside of the "wash" period of thirty days before and thirty days after the sale or by acquiring different securities which suit the taxpayer's purpose as well as those disposed of.

Sales of depreciable property at a gain to a spouse or controlled corporation result in ordinary gain instead of capital gain.[75]

The sale of shares of a collapsible corporation may under some circumstances result in ordinary rather than capital gains. The circumstances are somewhat under the control of the corporation and the shareholder and can be avoided.

Bargain sales by a corporation to a shareholder will result in having the Treasury treat the difference between the sale price and the value of the property as a taxable dividend to the shareholder.

Under some circumstances, the taking of notes from a buyer may convert capital gain into ordinary income. For example:

Seller sells capital assets for $10,000 receiving $2,000 in cash and $8,000 in notes of the buyer. The notes have a fair market value of $3,000, and the stock had a basis of $2,500. According to the decision in the *Culbertson* case,[76] the result is:

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[74] *Cramer*, 20 T.C. 679.

[75] See Section 7 of this Chapter.

[76] 14 T.C. 1421.

Capital gain:		
Cash	$2,000	
Note—Fair Market Value	3,000	$5,000
Basis of property		2,500
Capital gain		$2,500

Ordinary income:
Additional amounts realized on the notes beyond the $3,000 fair value included in the computation of capital gain.

This unfavorable result can be avoided if the buyer:

(a) Takes notes with an unascertained present value; receipts are capital gain.
(b) Takes notes that meet the requirements of Section 1231 (1939 IRC 117(f)) for securities of corporations (and government) in registered form or with interest coupons attached.
(c) Brings the transaction under the installment sales method.

Advance payments received without restriction from a customer are income when received, even by an accrual basis seller, even if work remains to be done or a guarantee period remains. An agreement by the seller to return the money if he does not perform fully might avoid this unfavorable result.[77] A better method is to segregate the funds, with the agreement that the seller has no right to them until performance has been completed; it is best to place such funds with a trustee.

16. Consider Alternatives to Taxable Sales and Exchanges

Abandonment of property may be more advantageous than its sale at a loss for a very nominal consideration if loss on a capital asset is involved. Sale results in capital loss, which is subject to the rules which limit the deductibility of capital losses; abandonment results in ordinary loss. The chief drawback to abandonment is the necessity for proving it to the satisfaction of the Treasury.

If the taxpayer has two Section 1231 (1939 IRC 117(j)) assets one of which he can sell at a gain and the other at a loss, he can get the best result by selling in different years[78] or by selling the gain asset and abandoning the loss asset if its value is very small. Assume a $5,000 gain and a $5,000 loss:

	Sale of Both	*Sale of One—Abandonment of Other*
Sale at gain	$5,000	$5,000
Sale at loss	($5,000)	
Abandonment		(5,000)
Aggregate result	$ 0	Cap. gain $5,000 Ordinary loss $5,000

III

CONCLUSION

To recapitulate, gain or loss is the difference between the proceeds of a sale or other disposition and the cost or other adjusted basis of the property disposed of.

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[77] *Woodlawn,* 16 T.C. 1067.
[78] See Section 13 of this Chapter.

Property may be ordinary assets, Section 1231 (1939 IRC 117(j)) assets, or capital assets. A disposition of ordinary assets results in ordinary gain or loss. A sale, exchange, or involuntary conversion of Section 1231 (1939 IRC 117(j)) assets results in a net capital gain or an ordinary net loss. A sale or exchange of capital assets results in capital gain or loss.

"Business property" is a term broad enough to cover all three classes of property. A business may hold property for investment, primarily for sale to customers in the regular course of business, or for use in trade or business. It is important that a clear determination be made as to which class the property is in, because its classification determines whether ordinary gain or loss or capital gain or loss results from its disposition. Rental and royalty property is considered to be used in trade or business and is not classified as investment property.

In many instances, the treatment of gain or loss depends upon whether or not the property is "sold or exchanged." It is not suitable to rely on the everyday popular concept of what a sale or exchange is or is not, because some unusual transactions are in some instances treated as sales or exchanges.

The length of time a piece of property has been held decides whether gain or loss is long-term or short-term; the dividing line is six months. In the case of most ordinary assets, the holding period is immaterial and has no effect on gain or loss. However, gain and loss on capital assets and Section 1231 (1939 IRC 117(j)) assets are seriously affected by the holding period.

Section 1231 (1939 IRC 117(j)) is very friendly to the taxpayer by limiting the tax on net gains, without disturbing a net loss. It applies to real and depreciable property held over six months and used in trade or business, to involuntary conversion of capital assets, and under some conditions, to coal and timber royalties, gains on the cutting of timber, and to the sale of unharvested crops.

The taxpayer can minimize his taxes by using some foresight in the way he enters into transactions, in choosing the form of transaction and the party to sell to, in timing his gains and losses, and in avoiding tax traps.

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66

Who Should Sell—Stockholder or Corporation—and How to Do It

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A corporation owns certain property. This property is substantial, and it is going to be sold.

You represent the people at the selling end of the transaction.

The sale is bound to have tax consequences, and your clients expect you to work it out in the way that will do them the most good (or the least harm) taxwise. This chapter is intended to help you in that regard, and to provide a tax guide of sorts for those in the position of selling property.

1. Points to Consider

To begin with, you will want to know:

	Section
What are the different methods you can use?	2
Which method to use if the sale is a gain transaction?	3
Which method to use if the sale is a loss transaction?	4

The answer to these questions involves the consideration of a variety of points. You have to decide which methods:

	Section
Will give just one tax on the gain?	5, 6
Will result in double tax on the gain?	5
Will result in only a single tax benefit from the loss?	5
Will give a double tax benefit from the loss?	5

In connection with these questions, there are a number of factors to be kept in sight. Some of them are:

	Section
How can you put to work deductions which otherwise would be wasted?	5
What if the corporation has no earnings and profits?	5
What if the stockholder itself is also a corporation?	5

Having determined which method ought to be best for you taxwise, you then will want to know what pitfalls you must beware of. Therefore, you will be interested in:

Section
What is the Service's attitude toward these methods? 5
What are the recent court decisions on these methods? 7, 8, 9
Checklist 10

2. The Different Ways

Broadly speaking, the alternative ways of handling this kind of deal are:

a. The corporation itself sells the property to the purchaser.

b. The stockholders sell their stock to the purchaser. (The purchaser then takes the property out of the corporation, usually by way of a liquidating dividend.)

c. The corporation distributes the property to the stockholders; thereafter they themselves sell the property.

Each of these methods has its respective advantages and disadvantages, dependent upon circumstances. The desirability of each turns, basically, upon whether, if the corporation itself should be permitted to make the sale, the sale would result in a gain or in a loss to the corporation.[1]

3. Gain Transaction. Which Is the Best Way, Generally?

Basically, if sale by the corporation itself would produce a gain to it, then that method definitely is the one *not* to be used.[2] However, the contrary is true if (as is probably the case) the transaction can fit within the pattern set by IRC § 337; in such case, sale by corporation may well be the most favored technique.

Otherwise, it usually is best to use the method in which the stockholders sell their shares to the purchaser.

And if the purchaser is not willing to do this (he probably will not be), then the next best thing is to have the corporation distribute the property to the stockholders, and have them sell the property.

4. Loss Transaction. Which Is the Best Way, Generally?

On the other hand, if sale by the corporation itself would result in a loss, use that method. Failing that, there is little to choose between the other two methods.

5. Which Way Is Best for Your Case?

The foregoing are only rules of thumb. The facts in a particular case may call for different application. Therefore, it is well to consider the reasons upon which these rules of thumb are based, to weigh them in the light of the facts in your case, and to decide whether they square with your case. If they do not, then perhaps in this instance you will want to use one of the alternative methods, rather than the one recommended first.

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[1] There are various nontax considerations that often enter into the selection of the particular method that is to be used in making the sale. Not being within the scope of this work, they will not be discussed here. See T. Paul Freeland, "Recent Trends in the Court Holding Company Principle," *Proceedings of New York University Seventh Annual Institute on Federal Taxation*, page 369. New York: Matthew Bender and Company, 1949.

[2] There is one exception to this rule that is discussed later at §§ 5 and 9, below.

These, then, are the reasons. Here, likewise, is one way to go about analyzing cases like this:

Preliminary analysis. First, ascertain the corporation's adjusted tax basis[3] for this property. Next, determine how much the property can be expected to bring in on the sale. Compare the two figures.

Will the property sell for more than the basis; will the corporation make a gain? Or will the sale result in a loss?

Let us suppose the sale shapes up to be a gain transaction. What then?

Gain transactions.

a. Fundamentally speaking, if you permit the corporation itself to make the sale, the proceeds are likely to be taxed twice.

Tax number one will be paid by the corporation. This will be either an ordinary income tax or a capital gains tax, depending on the character of the property.[4] Tax number two will be paid by the stockholders, upon the ultimate distribution to them of the remainder of these proceeds. Their tax, too, will be either ordinary income tax or capital gains tax, depending, however, upon whether the distribution is an ordinary dividend[5] or a liquidating dividend.[6] In any event, this technique generally inflicts double taxation at the selling end.

There is a possible exception to this rule, however. In one special type of situation, this method conceivably can be used without incurring any more than just one tax. This tax would fall not on the corporation, but on the stockholders, and would be only a capital gains tax.

Here is the idea:[7] The corporation sells the property, but not for the customary amount certain. Instead, the amount of the contractual purchase price is indefinite, being made contingent upon developments in future years.[8] Then, while the consideration is still contingent, the corporation is liquidated. As a liquidation dividend, the stockholders get the contingent consideration contract.

If all goes well, the corporation does not have to pay any tax at all on its sale of the property.[9] And the stockholder (if we assume that his basis is such that he derives a gain from the payments subsequently received by him under the contract) will have to pay only a capital gains tax.[10]

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[3] 1954 IRC § 1012; 1939 IRC § 113.

[4] 1954 IRC §§ 1201 and 1231; 1939 IRC § 117(c)(1) and (j). The question as to whether the property was held by the corporation for more than the required six-month period becomes important, if the maximum rate of 25 per cent is to apply.

[5] 1954 IRC §§ 61, 301(a); 1939 IRC §§ 22(a) and (e), 115.

[6] 1954 IRC §§ 302(a), 331; 1939 IRC § 115(c).

[7] There is no case that is squarely in point; this device has not yet been tested in the courts.

[8] For example: The corporation sells a patent in return for a percentage of the monies earned by the purchaser through the use of this patent during the rest of the patent's life.

[9] Because of its indefiniteness as to the amount due under it, the contract has no ascertainable fair market value. *Westover* v. *Smith* (9 Cir. 1949), 173 F. 2d 90, affirming, D.C. Cal., 1948; *Commissioner* v. *Susan J. Carter* (2 Cir. 1948), 170 F. 2d 911, affirming; 9 T.C. 364 (1947). Hence, there is not yet a closed transaction, and the realization of gain is therefore deferred to some year in the future. *Burnet* v. *Logan*, 283 U.S. 404, 9 AFTR 1453 (1931). But meanwhile before that comes to pass, the corporation will have been liquidated and dissolved out of existence, in accordance with plan.

[10] *Westover* v. *Smith*, footnote 9, above. See *Commissioner* v. *Susan J. Carter*, footnote 9, above. For a fuller exposition of this idea, see Samuel Brodsky, and John A. King, "Tax Savings through Distributions in Liquidation of Corporate Contracts," *Taxes*, September, 1949, Vol. 27, page 806.

A vastly more important exception to the rule, an exception which provides a long sought for method of securely avoiding the double tax, is now available as a result of IRC § 337, newly enacted into law in 1954. The corporate sale under § 337 has the great virtue of being free from the element of risk which is present in the "corporate contingent contract." Expressed briefly (in oversimplified fashion) Section 337 makes it possible for a corporation, of the type which qualifies for its use, to itself make the sale nonetheless entirely escape having to pay the tax. This will happen so long as the corporation is completely liquidated within a year and so long as the sale-property is a capital asset of the corporation. Handled properly, the transaction thus will produce only a single tax, payable by the stockholders; furthermore, this one tax will be a capital gains tax, measured by the overall gain on their stock investment which the liquidation realizes for the stockholders.

b. If the stockholders can get the purchaser to buy from them their stock certificates (rather than the asset), there will be only one tax paid at the selling end.[11]

This tax moreover will be only a capital gains tax, payable by the stockholders upon such gains as they may realize on their stock investment.[12] (Of course, if through this stock sale they can realize a loss, so much the better for this method: Not only will the corporation not be involved in a tax, but also the stockholders may get positive tax benefit from this transaction.)

c. Even if the purchaser insists upon buying the property, rather than the corporate stock, and even if for one reason or another the benefits of a "§ 337-sale" by the corporation are not available, nonetheless there remains another way of possibly avoiding the double taxation inherent in the "corporate sale" method. Here's how it is done: The stockholders cause the corporation to distribute the property into their hands; then they, themselves, sell the property.

This method gives the prospect of there being only one tax to pay at the selling end, the tax upon the stockholders.[13] If the distribution is in liquidation of the corporation, the tax will be a capital gains tax upon such gains as they thus realize on their stock investment.[14] (If what they realize is a capital loss, that, of course, is of use to them.)

Caution. Although in a gain transaction the method outlined in paragraph (c) above is normally preferable to the "sale by corporation" method (except, of course, where the benefits of a "§ 337-sale" are available to the corporation) it cannot at this point be said absolutely to be proof against double taxation. More about this later.

Loss transactions. Returning now to the comparison of the corporation's basis with the prospective sales price, suppose the sale will result in a loss. What then?

a. In such case, the "distribution to stockholders—sale by them" method is no longer satisfactory. Does it give the corporation a chance to get any good, taxwise, out of this drop in the value of its property? Does it, in other words, at least give the corporation a usable loss that it can set off against gains that it may have made in other transactions during the year? It does not. For this method involves a distribution in kind, and a corporation is not deemed to have sustained a loss when it makes a distribution in kind. That is true whether the distribution is in the form of an ordinary dividend,[15] or a dividend in liquidation of the corporation.[16] No tax good therefore will be felt by the corporation, if this method is employed.

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[11] See *United States* v. *Cumberland Public Service Company*, 338 U.S. 451, 38 AFTR 978 (1950). See the discussion and cases cited in § 7, below.

[12] 1954 IRC §§ 1221, 1222; 1939 IRC § 117.

[13] The corporation's claim to freedom from tax on this transaction springs from Reg. 111, § 29.22(a)-20, in the case of liquidating dividends, and *General Utilities and Operating* Co. v. *Helvering*, 296 U.S. 200, 16 AFTR 1126 (1935), in the case of ordinary dividends.

[14] 1954 IRC § 301(a); 1939 IRC § 115(c). See the discussion and cases cited in § 6, below.

b. If however you let the corporation, itself, make the sale, then it does stand to derive some tax advantages from the transaction, for there is no question that in such event the corporation's loss will be recognized (unless the transaction comes within the orbit of a § 337 complete liquidation; losses, just like gains, are not recognized under § 337).[17]

Generally, that loss can be used to make money for the corporation. It will do so if the loss is more than large enough to offset the gains made by the corporation during the rest of the year, so that a net operating loss results.[18] With a carry-back of this net loss, it will be possible to get a refund, if the corporation did pay income taxes during either of the preceding years.[19]

Even if it does not actually make money for the corporation, the loss is at least likely to save some money for it. It will do so to the extent that it offsets taxable gains made by the corporation during the year. That is unquestionably the fact if the property is a noncapital asset, i.e., stock in trade, inventory, depreciable property used in the business, or real property used in the business.[20]

At the same time you should not forget that if the property is a capital asset, the loss realized by the corporation on its sale, even though not entirely without value, will be of more limited aid. For, as far as cutting down on the current year's tax is concerned, its possibilities are curtailed. Corporate capital losses may be used only against capital gains. They result therefore in current tax benefit only to the extent that there are capital gains that these losses could serve to wipe out.[21]

Of course, if it is contemplated that the corporation will stay in business even after the sale, the capital loss then has a greater potential usefulness than if the corporation is to be liquidated. If the corporation should make net capital gains in the next five years, then any net capital loss arising out of this particular sale may help, as a carry-over, to level them.[22]

This increased potential resulting from a proposed continuation of the corporation's business activities also applies in the case of a noncapital asset loss. This can be carried over for the next five years.[23]

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[15] *General Utilities and Operating Co.* v. *Helvering*, 296 U.S. 200, 16 AFTR 1126 (1935); *First Savings Bank of Ogden* v. *Burnet* (D.C. Cir. 1931), 53 F. 2d 919, 10 AFTR 732. IRC § 311(a).

[16] Reg. 111, § 29.22(a)-20. IRC § 311(a).

[17] 1954 IRC §§ 165, 1221, 1222; 1939 IRC §§ 23(f), 117(a)(1). *Evansville Oil Corp.*, par. 53,016 Prentice-Hall Memorandum T.C. (1953). It also is not so if the corporation is going soon to be liquidated and if the sales contract calls for a purchase price that is indefinite in amount, being contingent upon developments in future years. *Burnet* v. *Logan*, footnote 9, above.

[18] 1954 IRC § 172, 1939 IRC § 122. *Acampo Winery and Distilleries*, 7 T.C. 629 (1946).

[19] See *Acampo Winery and Distilleries, Inc.*, footnote 18, above. See *Gorman Lumber Sales Company*, 12 T.C. 1184 (1949).

[20] See 1954 IRC §§ 1221, 1222; 1939 IRC § 117(a)(1).

[21] 1954 IRC § 1211; 1939 IRC § 117(d)(1).

[22] 1954 IRC Sec. 1212; 1939 IRC § 117(e)(1). But see discussion under the caption "Partial Liquidation," later in this chapter.

Thus, in a loss situation the simple "sale by corporation" method is preferable to the "distribution to stockholders—sale by them" method.

c. The "sale by corporation" method likewise is preferable to the "stock sale" method. The same reason applies. The "stock sale" method deprives the corporation of the chance to use the loss in order to get back or to save its taxes. The only time any use will be got out of the loss this way is where, in computing the stockholders' taxes, the property loss may indirectly lower the individual income taxes attributable to their receipt of the liquidating distribution. Even in the most extreme form, however, it can result only in a mere capital loss.[24]

Accordingly, when there is a loss situation, it usually is best to have the corporation itself make the sale of the property.

Further considerations. On the whole, these rules are based upon a desire to avoid the double tax effect that is ordinarily characteristic of the less preferable methods. But the facts in your case may be out of the ordinary. Therefore, check your facts against the possibility that this objectionable feature actually is not present in your case.

Thus, in a gain situation the objection to using the "sale by corporation" method tends to disappear, if the corporation happens to have deductions that are sufficient to offset the gain. The first tax will vanish.

But this objection reappears if it develops that these losses can be used profitably otherwise. That will hold if the corporation has other potential gains that these losses could serve to offset. This is likewise the case if these losses can be used to build up a net operating loss with which to obtain refund of previously paid taxes.

If the stockholder is a corporation, too—and the distribution to the stockholder after "sale by corporation" is an ordinary dividend of earnings—the double taxation becomes less significant. Reason: Owing to the dividends received credit, the second tax, falling upon the corporate stockholder, will amount to no more than 7.8 per cent of the distribution.[25]

Furthermore, if the distribution is out of capital (rather than earnings), then there will be no second tax at all, such distributions being tax-free to the stockholder, corporate or otherwise.[26]

The Service's attitude. The Service has not been unaware of the tax minimization features of these methods, and it has resisted most of them. In gain situations, the Commissioner has been trying to double-tax the sale proceeds. Hence, in cases where the corporation itself had not been permitted to make the sale, the Commissioner nonetheless has been asking the courts to treat the corporation as though it had been indeed the seller, and to impose a tax upon the corporation. He no longer seems to be using this approach with the "stock sale" method, having dropped the fight on that front, apparently. But not so with the "distribution to stockholders sale by them" technique; although in very recent years he has been losing more of these cases than he has been winning, there is no sign that he is going to stop combatting this method.

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[23] 1954 IRC Sec. 172; 1939 IRC § 122(b)(2), as amended by The Revenue Act of 1950.

[24] Of course, if the stockholder is a "dealer" in corporate securities, the stock would not be a capital asset if held by him primarily for sale to customers. See 1954 IRC Sec. 1221, 1222; 1939 IRC § 117(a)(1). In such case, the loss would be treated as an ordinary loss, without the limitations ordinarily applicable to capital losses.

[25] 1954 IRC Sec. 301.

[26] See 1939 IRC § 115(d).

6. Section 337 Sale by Corporation

By following § 337, a corporation generally can make a gainful sale of its assets and then distribute the proceeds to its shareholder, in liquidation, at the cost of but a single tax.

The single tax falls upon the stockholder; no tax is due from the corporation, under this section.[27]

Here is how it works. The corporation must first adopt a plan of liquidation. This has to be a plan of complete liquidation;[28] partial liquidation will not do. It then has twelve months[29] in which to sell, or exchange,[30] as much or as little of its property as it wants to dispose of that way. Also, by the time the end of that twelve-months period comes around, the corporation must have liquidated completely, distributing all of its assets[31] (except for so much as it retains in order to meet claims).[32]

If this is done, usually no gain or loss will be recognized to the corporation from the sales or exchanges of its property made by it within that twelve-months period.[33]

However, there are exceptions to this. Collapsible corporations cannot benefit from or be affected by this section.[34] Neither can corporations being liquidated partially tax free (within one month) under the election provided in § 333.[35] Neither can subsidiary corporations being liquidated tax free under § 332 [36] (that being true, however, to only a limited extent in the case of any subsidiary which falls within § 334(b)(2), since in such case gain realized by the parent in the liquidation will be recognized, only in part).[37]

Furthermore, even where the corporation does come within the purview of § 337, not all of its property is necessarily protected thereby from double tax. Thus, as a rule the corporation's gains from the sales or exchanges of its stock in trade, inventory, or property held primarily for sale in the ordinary course of business will still be taxed twice.[38] So will gains similarly derived from installment obligations accepted by the corporation in return for any of its property of these same categories.[39] For that matter, even if the installment obligation in question stems from a deal involving corporate property which is not in these particular categories, gain from the sale or exchange of this installment obligation will nonetheless be susceptible to double taxation, if the deal in which the installment obligation was acquired took place before the liquidation plan was adopted.[40]

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[27] 1954 IRC § 337(a). If not for the relief provided by the 1954 Code, in the form of § 337, there would be two taxes paid, of course. Thus, even now a corporate sale can still result in double taxation, if the requirements of § 337 are not met.

[28] 1954 IRC § 337(a)(1).

[29] The twelve-month period begins on the date of the adoption of the plan of liquidation. IRC § 337(a)(2). However, just exactly when is the plan adopted? On the date of approval by the stockholders of the resolution embodying the plan? Not necessarily, if the Commissioner has things his way: his proposed regulation would have it that the plan be deemed to have been adopted even before that. Prop. Reg. § 1.337-2(b).

[30] 1954 IRC § 337(a)(2). But note that the proposed regulation (Prop. Reg. § 1.337-2(a)) creates still more uncertainty, this time as to the date when the sale or exchange should have been deemed to have occurred. The Commissioner carefully avoids saying that it takes place on the date when title passes. This becomes important in connection with the requirement (see note 29, supra) that the sale or exchange take place within the twelve-month period.

[31] Ibid.

[32] Ibid

[33] Ibid.

[34] See 1954 IRC § 337(c)(1)(A). See also Prop. Reg. § 1.337-1(a).

[35] See 1954 IRC § 337(c)(1)(B).

[36] See 1954 IRC § 337(c)(2)(A).

[37] See 1954 IRC § 337. Consider also Prop. Reg. § 1.337-4(c).

However, there is an exception to these exceptions. If substantially all the property of these categories which the corporation owns is sold or exchanged in a "bundle," i.e., in one deal to one person, the gain or loss from the transaction will not be recognized (so long as Section 337's other requirements are met).[41]

Naturally, it is all very well to use § 337 in order to get away from the double tax in potential gains. But what if the corporation has other assets which represent potential losses? Is there some way of avoiding the extra tax on the gains without thereby sacrificing the loss deductions? There is. It is just a matter of timing. Before adopting any plan of liquidation under § 337, the corporation should first sell its loss property—and should thus realize losses which, not being affected by § 337, will be deductible.[41a]

7. Distribution to Stockholders—Sale by Them[42]

Before 1954, the year when the provisions of § 337 first appeared in the Code, this "distribution to stockholders—sale by them" technique was the one which most often was employed by sellers in their attempt to escape the double tax. The advent and the advantages of § 337 can be expected to reduce dramatically the future use of this technique in situations where a complete liquidation is practicable. However, § 337 is not of universal availability, for not every complete liquidation and not every type of asset can qualify for the tax escape which lies in § 337. Furthermore, a successful going concern will be reluctant to resort to complete liquidation. Hence, it can be expected that situations will continue to crop up where tax advisers will have to consider at least the possible attractions of a distribution to stockholders-sale by them.

Broadly viewed, this property distribution to stockholders could be accomplished in complete liquidation of the corporation; alternatively, the property might instead be distributed as an ordinary dividend in kind, by a going concern; alternately, the property could be distributed in only partial liquidation of the corporation. The discussion which follows is intended to throw some light on the income tax consequences of each of these alternative techniques.

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[38] See 1954 IRC § 337(b)(1)(A). By the same token, losses incurred in such sales or exchanges will be recognized, likewise.

[39] See 1954 IRC § 337(b)(1)(B).

[40] See 1954 IRC § 337(b)(1)(C).

[41] IRC 1954 § 337(b)(2).

[41a] But beware of the last sentence in Prop. Reg. § 1.337-2(b), which was published after the material in the text above went to press, and which doubtless is intended by the Commissioner to assist him in thwarting this loss-realization technique.

[42] For the sake of simplicity and to avoid belaboring the subject, the discussion that follows will assume that we are dealing with a gain situation.

Complete liquidation. In cases of this type, if the liquidation distribution to the stockholders is "genuine," the corporation cannot be taxed as the seller. If the distribution is not genuine, the corporation can and will be taxed.[43]

Theoretically, it is as simple as that. But as a practical matter, it is much more difficult. For the practical question immediately arises: Just how should you handle things so as to cause the liquidation distribution in your case to be treated as genuine? To that there is no certain answer.

No court has ever told us just exactly what the point is at which a distribution ceases to be genuine and becomes sham. And despite the fact that in the past few years the decisions have indicated a trend which is encouraging to the taxpayer, it still is necessary to handle with care.

In fact, even following the Supreme Court's decision in the *Cumberland* case it was possible for a time to say that the odds actually were against you. Most of the cases until then had gone against the corporate taxpayer.[44] That had been particularly true in the Tax Court, which from the first had not been overly partial to this tax avoidance device. (Even now, the Tax Court includes some judges who seem to react adversely to it.) Under the circumstances, despite the fact that the taxpayer's position has seen considerable improvement recently, it remains correct to feel that we can speak a little more knowingly of what you should not do than what you should do.

In any event, one thing is clear: Whenever the fact has been shown in court that the distribution was brought about by a desire to escape tax, it has not proved helpful.

Certainly, that was true before the *Cumberland* decision. Indeed, one judge went so far as to hold that so long as a distribution was motivated by tax considerations, the corporation necessarily had to be taxed as the seller.[45] This view proved to be too extreme for the Supreme Court, which cut it down in the *Cumberland* case.[46] We now know definitely that the tax avoidance motive does not, of itself, absolutely require a decision against the corporation.[47]

That does not justify rash complacence. For at the same time the Supreme Court has also told us that, even though not necessarily controlling, the tax avoidance motive is not to be ignored. Instead, it is something that the trial court should consider with all the other relevant circumstances in the case in making up its mind whether the liquidation distribution was sham or genuine.[48]

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[43] *United States* v. *Cumberland Public Service Company*, 338 U.S. 451, 37 AFTR 1333, affirming 83 F. Supp. 843 (Ct. Cls. 1949).

[44] See collection of cases in 3 Prentice-Hall 1953 Federal Tax Service 28, 215-28, 216. The discussion in the text of this Chapter will concern itself primarily with the more recent decisions only, since the older cases can be of only limited value in the handling of this subject.

[45] *Guiness* v. *United States*, 73 F. Supp. 119, 36 AFTR 108 (Ct. Cls., 1947), cert. den. 334 U.S. 819 (1948). However, this involved an ordinary dividend rather than a distribution in liquidation.

[46] *United States* v. *Cumberland Public Service Company*, 338 U.S. 451, 37 AFTR 133, affirming 83 F. Supp. 843 (Ct. Cls., 1949).

[47] *Ibid.*

[48] *Ibid.* Accord, *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 33 AFTR 593 (1946), reversing (5 Cir. 1944) 143 F. 2d 823, 32 AFTR 1088, reversing 2 T.C. 531 (1943).

The fly in the ointment is this: The weight that is to be given to each item in a case inevitably depends to some extent upon the personal idiosyncrasies of the trier of the facts. That being so, it is conceivable that, given a trial judge who has an instinctive antipathy to tax avoidance devices, you may find yourself winding up with a "sham distribution" a finding of fact which an appellate court would consider itself powerless to reverse, despite any uncomfortable impression that the trial judge had given undue weight to the tax avoidance motive.

For that reason, misgivings were felt originally that, in the Tax Court at least, proof that the liquidation was prompted by a desire to avoid taxes very possibly would continue to control the outcome, as a practical matter—*Cumberland* precedent or not.

That this concern was not entirely unwarranted was soon demonstrated in the *Doyle Hosiery* case.[49] There, even though the essential facts of the case squared with those which in the *Cumberland* case had in effect produced a finding by the Court of Claims that the liquidation was genuine, there were five judges of the Tax Court who denounced the "carefully clocked ritualistic formalities" which had been employed in the distribution and sale, and jointly insisted in a dissenting opinion that the Doyle corporation should be taxed.

Fortunately for the taxpayer, however, the majority of the Tax Court ruled differently, in a guidepost decision in favor of the Doyle corporation. Furthermore, despite indications that anti-tax avoidance sentiment still exists,[50] the other Tax Court decisions since the *Cumberland* case have been uniform in likewise treating the tax avoidance motive as not decisive. Notwithstanding the unmistakable presence of the tax avoidance motive, the Tax Court ruled for the taxpayer in *Beaty*,[51] in *Gilman*,[52] in *Klous*,[53] and in *West Coast Securities*.[54]

But there is no reason to think that the Tax Court will decide against taxing the corporation in a case where the corporation first makes a contract to sell the property in question, but, before performing, distributes the property to its stockholders as a liquidating dividend, thus enabling them to sell it to the same purchaser on the same terms. That is the pattern that proved unsuccessful before the Tax Court in the noted *Court Holding Company* case,[55] and there is nothing in the *Cumberland* opinion to cause the Tax Court to change its mind about like situations. You may expect the Tax Court to continue to tax corporations in that type of case, whether the original contract was in writing[56] or not.[57]

In the improbable event that you could succeed in satisfying the Court that in your case there positively is no taint of tax-avoidance motive, your prospects would improve greatly, of course. Especially is that true if, in addition, the corporation has been officially dissolved, as well as fully liquidated. (Added luster would be supplied if you were yet further to differentiate your case from the *Court Holding*

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[49] *Doyle Hosiery Corporation*, 17 T.C. 641 (1951).

[50] See dissents in *West Coast Securities Co.*, 14 T.C. 947 (1950).

[51] *Amos L. Beaty & Co., Inc.*, 14 T.C. 52 (1950).

[52] *Frank E. Gilman, Transferee*, 14 T.C. 833 (1950).

[53] *Isidore P. Klous, et al., Transferees*, par. 52,105 Prentice-Hall Memorandum T.C. (1952).

[54] *West Coast Securities Co.*, footnote 50, above.

[55] *Commissioner* v. *Court Holding Co.*, 2 T.C. 531 (1943), reversing (5 Cir. 1944), 143 F. 2d 823, 32 AFTR 1088, reversing 324 U.S. 331, 33 AFTR 593 (1946). But compare *Burley Tobacco Warehouse, Inc.* v. *Glenn* (D.C., W.D. Ky. 1952), — F. Supp. —

[56] See *Nace Realty Co.*, 28 B.T.A. 467 (1923), affirmed without opinion by 6 Cir., 1935.

[57] *Commissioner* v. *Court Holding Co.*, footnote 48, above.

Company case, by showing that the stockholders have not credited the purchaser with a down payment previously made by him to the corporation.)[58]

Suppose it is not conceded that the distribution had been preceded by a corporate contract. What is the Tax Court approach then? There is no clearly defined answer to this. However, the Court is apparently very much influenced by the chronology of the events surrounding the distribution.

Before the *Cumberland* decision, it was generally felt that the Tax Court would tax the corporation if it developed that negotiations with the purchaser were carried on before the liquidation took place.[59] However, the picture is notably different now; since *Cumberland* the Tax Court has indicated, on three occasions, that pre-liquidation negotiations are not necessarily fatal to the case for freedom from corporate tax.[60]

Thus, despite the fact that protestations that the negotiations had been carried on only in the name of the stockholders, and not in the name of the corporation, had proved unavailing in the days before *Cumberland*[61]—the more recent cases demonstrate that this defense is now likely to meet with an appreciably better reception there. Whereas proof that nobody ever intended the corporation to be a party to the contract used to have no effect upon the Tax Court previously,[62] now the reverse is to be expected. Before, the fact that the deal was struck while title was still in the corporation had been held sufficient cause for taxing the corporation, regardless of the fact that at all times it was on behalf of solely the stockholders that the transaction was being negotiated;[63] since *Cumberland*, however, the Tax Court has decided this type of case for the taxpayer.[64]

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[58] In *Court Holding Co.*, the trial court found that the tax-avoidance motive was at the bottom of the distribution to the stockholders, that the corporation had never been dissolved, and that, in making the purchase price adjustments, the stockholders had allowed the purchaser the amount that he had paid to the corporation as a down payment at the time when the corporation openly was selling the property to him.

[59] See Charles W. Tye, "Corporate Distributions—Some Current Trends," *Tax Law Review*, May 1949, Vol. 4, pages 459-466. See also Allan F. Ayers, Jr., "Stockholder or Corporate Sale of Assets in Liquidation as Affected by Court Holding Company and Howell Turpentine," *Proceedings of New York University Sixth Annual Institute on Federal Taxation*, pages 364-373. New York: Matthew Bender and Company, 1948.

[60] *Amos L. Beaty & Co., Inc.*, footnote 51, above; *Doyle Hosiery Corporation*, footnote 49, above; *Michael J. Shagan, et al., Transferees*, par. 52,223 Prentice-Hall Memorandum T.C. (1952).

[61] *Fairfield Steamship Co.* v. *Commissioner*, 5 T.C. 566 (1945), affirmed (2 Cir. 1946) 157 F. 2d 321, 35 AFTR 117, cert. den. 67 Sup. Ct. 193 (1946); *Rose Kaufmann*, 11 T.C. 483 (1948), affirmed (3 Cir. 1949) 175 F. 2d 28; *Howell Turpentine Company* v. *Commissioner*, 6 T.C. 364 (1946), reversed (5 Cir. 1947), 162 F. 2d 319, 35 AFTR 1459; *Court Holding Co.* v. *Commissioner*, footnote 32, above; *Borall Corp.* v. *Commissioner*, par. 46,256 Prentice-Hall Memorandum T.C. (1946), affirmed (2 Cir. 1948) 167 F. 2d 865, 36 AFTR 988. But compare these cases with *Cumberland Public Service Company*, 83 F. Supp. 843 (Ct. Cls. 1949), footnote 43, above; *Louisville Trust Co.* v. *Glenn*, 65 Supp. 193 (D.C. Ky., 1946), 34 AFTR 1238, affirmed *sub nomine United States* v. *Cummins Distilleries Corp.*; (6 Cir. 1948), 166 F. 2d 17, 36 AFTR 733.

[62] See *Fairfield Steamship Co.*, footnote 61, above; *Rose Kaufmann*, footnote 61, above; *Howell Turpentine Company*, footnote 61, above.

[63] *Howell Turpentine Company*, footnote 61, above; *Rose Kaufmann*, footnote 61, above. Also, *Fairfield Steamship Co.*, 5 T.C. 566 (1945), affirmed on other grounds (2 Cir. 1946) 157 F. 2d 321, 35 AFTR 117, cert. den. 67 Sup. Ct. 193 (1946). See *The Wichita Terminal Elevator Co.*, 6 T.C. 1158 (1946), affirmed (10 Cir. 1947) 162 F. 2d 513, 35 AFTR 1487. But see *George T. Williams*, 3 T.C. 1002 (1944). Compare *Cumberland Public Service Company* (Ct. Cl.), footnote 46, above.

[64] *Amos L. Beaty & Co., Inc.*, footnote 51, above.

Notwithstanding this post-*Cumberland* trend a caveat is in order. In none of its opinions has the Tax Court eliminated, in so many words, pre-liquidation negotiations as a factor to be taken into account. Instead, from the rather gingerly way in which the court's opinions have approached the subject, the inference is left that in a close enough case a history of pre-liquidation negotiations may yet make the difference between tax and no tax.

Obviously, letting an officer of the corporation conduct the preliquidation negotiations is not calculated to help dispel the suspicion that the negotiations were entered into on behalf of the corporation;[65] especially is that true where the officer is not even a stockholder.[66] Nor does it pay to have the documents connected with your liquidation so ambiguous in phraseology that they lend themselves to an adverse construction.[67] For the same reason, you ought to be particularly careful to avoid ambiguity where a liquidating committee, trustee, or agent is going to be used to make the sale; it should be made clear that the committee, trustee, or agent is acting solely for the stockholders and not for the corporation. Laxness on this score can result in double tax,[68] even if negotiations for sale are not commenced until after the liquidation.[69]

But where the conversations with the purchaser, although held prior to the distribution, were merely exploratory in character and did not touch on price or the particular assets that were sold, so that they did not warrant being dignified with the status of negotiations, the Tax Court did not sustain the Commissioner's attempt to tax the corporation.[70] The same thing happened in a case where, although negotiations definitely had taken place, they ultimately had been dropped, and even the thought of a deal abandoned, long before the liquidation distribution was made; only sheer coincidence brought the same purchaser and the stockholders together, following a public advertisement for bids.[71] When the stockholders' negotiations were not begun until after the liquidation distribution, the Tax Court summarily rejected the Commissioner's effort to tax the corporation.[72]

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[65] This was one of the damaging facts in *The Wichita Terminal Elevator Co.*, footnote 63; *Howell Turpentine Company*, note 61. *Cf. Court Holding Co.*, note 48. But compare with these cases *Doyle Hosiery Corporation*, footnote 49, above; *Cumberland Public Service Company* (Ct. Cl.), note 46.

[66] See *Rose Kaufmann*, note 61. Compare *St. Louis Union Trust Co., Exec.* (Sternberg Est.) v. *Finnegan* (8 Cir. 1952), 197 F. 2d 565.

[67] *Borall Corp.*, footnote 61, above.

[68] *Ibid.* Also, *Meurer Steel Barrel Co.*, par. 43,113 Prentice-Hall Memorandum T.C. (1943), affirmed (3 Cir. 1944) 144 F. 2d 282, 32 AFTR 1189, cert. den. 324 U.S. 860 (1945). But compare the following cases, where there was no ambiguity, so that the court found that the trustee or agent was acting for the stockholders, and therefore held the corporation was not to be taxed. *Ripy Bros. Distilleries, Inc.*, 7 T.C. 629 (1946); *Louisville Trust Co.* v. *Glenn*, note 39. Compare also *Standard Realization Co.*, 10 T.C. 708 (1948).

[69] Where corporate liquidations are effected through trustees or agents, gains from sales are taxable to the corporation as though it were a going concern. See *First Nat'l Bank of Greeley, Colorado* v. *United States* (10 Cir. 1936), 86 F. 2d 938, 941, 18 AFTR 694, affirming 9 F. Supp. 28, 14 AFTR 1107 (D.C. Col., 1934). Thus, if the designation of the trustees, agents, or committee of the stockholders is so ineptly handled as to result in a finding that the representative was acting for the corporation rather than the stockholders, a sale conducted by the representative would be taxed to the corporation regardless of the fact that it was initiated only after the liquidation of the corporation.

[70] *H. Dixon Smith*, par. 49,215 Prentice-Hall Memorandum T.C. (1949).

[71] *Acampo Winery and Distilleries, Inc.*, footnote 18, above. See also *Armored Tank Corporation*, 11 T.C. 644 (1948). Compare too *Cumberland Public Service Company* (Ct. Cls.), footnote 46.

On the basis of most recent performance, the Court of Claims appears to be a much better risk from the taxpayer's viewpoint for the trial of this sort of case than the Tax Court. It is true that one of its two decisions touching on the subject was in favor of the government.[73] But the effect of this has been nullified by the Court of Claims' handling of the more recent *Cumberland* case, in which it rendered judgment for the taxpayer. *Cumberland* is a case in which the transmission equipment of a closely held power company was sold to its REA competitor, which had driven it out of business. After an effort to handle the deal by way of a sale of all the stock fell through, the corporation's stockholders, for tax reasons only, rejected an offer to purchase directly from the corporation itself, and then proceeded to negotiate a transaction calling for a sale to be made by the stockholders following a liquidation distribution. Thereafter, they instituted dissolution proceedings, caused the corporation to make a partial liquidation distribution consisting of the transmission equipment, and consummated the sale in their capacity as stockholders. Subsequently, as the liquidation committee, they sold the balance of the corporate property and ultimately distributed the proceeds in complete liquidation of the corporation, which meanwhile had been officially dissolved. In 1949 the Tax Court probably would have decided this case for the Government. However, the Court of Claims did not; instead, it found (4-1) that the corporation was not the seller and was not to be taxed as such.

Because of their great number and individuality, it is not possible to utter about the Federal district judges even such hesitant generalities as have been written above about the Tax Court and the Court of Claims. Suffice it to note that seven post-*Court Holding Company* District Court cases involving the use of this method have been decided in favor of the taxpayer;[74] one was decided against the taxpayer.[75] It should also be remembered that in the District Court it is possible for a taxpayer to obtain a trial by jury, a privilege of which advantage should be taken in suitable cases.

The result of liquidations of this nature hinges primarily upon the findings of fact of the trial tribunals, and consequently one might think that the Circuit

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[72] *J. T. S. Brown's Son Co.*, 10 T.C. 840 (1948). *Frank E. Gilman, Transferee,* footnote 52, above; *West Coast Securities Co.*, footnote 50, above (three judges dissented). See also *Standard Realization Co.*, footnote 68, above. (Negotiations with the purchaser were initiated by a newly created selling corporation, organized by stockholders of a defunct corporation to dispose of properties received by them from the old corporation.)

[73] *Guiness* v. *United States*, footnote 45, above.

[74] *P. V. Burke* v. *Smyth*, 1949 Prentice-Hall par. 72,550 (N.D. Cal., 1948); *Baum* v. *Dallman*, 76 F. Supp. 410, 36 AFTR 1351 (S.D. Ill., 1948); *Louisville Trust Co.* v. *Glenn*, note 61; *Burley Tobacco Warehouse* v. *Glenn*, footnote 41, above; *Jones* v. *Grinnell* (W.D. Okla., 1950), unreported decision, reversed (10 Cir. 1950), 179 F. 2d 873; *Hull Hotel Co.* v. *Riddell* (S.D. Cal., 1953), Prentice-Hall par. 72,568; *Fred F. Horschel* v. *U.S.* (E.D. Wash.), unreported decision, affirmed (9 Cir. 1953) 205 F. 2d 646.

[75] *St. Louis Union Trust Co., Exec.* (*Sternberg Est.*) v. *Finnegan* (E.D., Mo. 1951), 100 F. Supp. 1020, reversed (8 Cir. 1952), 197 F. 2d 565.

Courts are relatively limited in what they can do in these cases. However, the U.S. Court of Appeals for the Fifth Circuit three times has shown its impatience with anti-taxpayer decisions of the Tax Court and has reversed in favor of the taxpayer,[76] going to great lengths to do so in the latest of these decisions.[77] The Sixth Circuit likewise has demonstrated a receptive attitude to the arguments of the taxpayer.[78] The same is true of the Eighth Circuit, which has showed itself ready to reverse the District Court's unfavorable finding of fact in order to produce a decision for the taxpayer.[79] The Ninth Circuit affirmed the District Court's pro-taxpayer decision.[80] But both of the decisions of the Second Circuit have sustained decrees holding the corporation taxable as the seller.[81] Indeed, in one of these cases the affirmance was rendered in spite of the fact that the appellate court rejected the theory upon which the Tax Court had based its decree.[82] The Third Circuit likewise has not provided a comfortable environment for those who use this method.[83] The Tenth Circuit, in one case that came before it, supported the Tax Court's determination in favor of the Government,[84] and, more significantly, disagreed with the District Court's findings of facts in the other case and reversed the lower court's decision, which had been for the taxpayer.[85]

On the whole, especially in view of the more liberal trend which latterly has manifested itself in the Tax Court, the prospects for achieving tax minimization by means of the proper use of the "distribution to stockholders-sale by them" technique, are generally good where a complete liquidation is involved.[86] Particularly is that true if the taxpayer is so fortunate as to be situated in a circuit like, for instance, the aggressively favorable Fifth Circuit. However, the outlook is more hazardous for the taxpayer who happens to be in a circuit which, like the Second Circuit, has an appellate court that long and effectively has tended to exercise its formidable intellectual adroitness to the increase of the revenues; in such case the tax planning should be as discreet as possible, using the fact-pattern of the *Cumberland* case as at best the outermost limits of safety.

Ordinary dividend in kind. If it was only in order to escape the corporate tax that the corporation distributed its property as an ordinary dividend in kind, the subsequent sale of the property by the stockholders must be taxed to the corporation, as though it were the seller.

That is what the U.S. Circuit Court of Appeals for the Second Circuit indicated in *Transport Trading & Terminal Corporation.*[87] That likewise is what the prevailing opinion for the Court of Claims stated in an earlier case.[88]

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[76] *Court Holding Co.* v. *Commissioner*, footnote 48, above; *Howell Turpentine Company*, footnote 61, above.

[77] *J. T. Wurtsbaugh, Transferee* v. *Commissioner* (5 Cir. 1951), 187 F. 2d 975, reversing 13 T.C. 1059 (1949). (The corporation had made the contract to sell; this was done in contemplation of liquidation.)

[78] *United States* v. *Cummins Distilleries Corp.*, footnote 61, above.

[79] *St. Louis Union Trust Co., Exec.* (*Sternberg Est.*) v. *Finnegan*, footnote 75, above.

[80] *U.S.* v. *Fred F. Horschel*, footnote 74, above.

[81] *Fairfield Steamship Co.* v. *Commissioner*, footnote 61, above; *Borall Corp.*, footnote 61, above.

[82] *Fairfield Steamship Co.* v. *Commissioner*, footnote 61, above.

[83] *Rose Kaufmann* v. *Commissioner*, footnote 61, above; *Meurer Steel Barrel Co.* v. *Commissioner*, footnote 61, above.

[84] The *Wichita Elevator Co.*, footnote 63, above.

[85] *Jones* v. *Grinnell*, footnote 74, above.

[86] For ordinary dividends and for certain types of distributions in partial liquidation, the contrary is true. See discussion which follows in text of this chapter.

A dividend in kind distributed by a going concern with the reasonable expectation of immediate sale invites the double tax, regardless of whether the expectation is based upon previously negotiated arrangements[89] or merely the favorable state of the general market [90]—if the distributed property is indeed thereafter sold. This may well continue to be as true of post-1954 transactions as it is in the case of distributions made before the 1954 Code became operative. For it is open to question, whether in situations of this type the new IRC § 311(a) will be effective to prevent the corporation from being taxed in the face of the *Lynch* and *Transport Terminal* opinions, since they purport to tax the corporation not on the distribution of the property but rather on the subsequent sale of the property. Only time and future court decisions are likely to resolve this uncertainty. Meanwhile, caution should be the watchword.

Partial liquidation. A sale of property received in a distribution which, while in partial liquidation, is made as a phase of a complete liquidation and dissolution that soon are brought to pass, falls within the pattern of the *Cumberland* case.[91] It therefore is possible for this type of distribution in kind to be made without subjecting the corporation to tax, even though it is made with the sure expectation of sale by the stockholders and even though it frankly is prompted by a desire to escape the double tax.[92]

Where the partial liquidation is not shortly succeeded by a winding up and termination of all the corporation's affairs, but instead the corporation carries on as a going concern,[93] the picture is more obscure. At present the possibility exists that in this type of situation it will be held that a finding of tax-escape motivation makes mandatory the imposition of the tax upon the corporation. This possibility is created by the argument that the *Cumberland* precedent and its generous attitude towards tax avoidance do not apply to "going concerns." This argument already has been advanced by the Commissioner, with success, in the ordinary dividend cases.[94] It is to be assumed that it will be advanced by him in this type of case, too, when the occasion first presents itself.[94a]

Consequently, if the corporation is going to stay in business, the partial liquidation technique should be used only as a calculated risk.

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[87] (2 Cir. 1949), 176 F. 2d 570 reversing 9 T.C. 247 (1947), cert. den. 338 U.S. 955.

[88] *Guiness v. United States*, footnote 45.

[89] *Transport, Trading & Terminal Corp.*, footnote 87, above.

[90] *U.S. v. P. J. Lynch* (9 Cir. 1951), 192 F. 2d 718, reversing (D.C., E.D. Wash.), unreported decision, cert. den. 343 U.S. 934.

[91] *Cumberland Public Service Company v. United States*, footnote 46, above.

[92] See the discussion of *Cumberland* in the text, page 1109 above. Notwithstanding this, it should be borne in mind that where the distribution would be just a phase in what is expected to be in the not too distant future a complete liquidation, it would be unwise not to consider the possible preferability of conducting the whole matter under the protection of IRC § 337.

[93] For example: Where all the shares of only one of the stockholders are redeemed. See 1939 IRC § 115(i).

[94] See *U.S. v. P. J. Lynch*, footnote 90, above. See also the government's brief in opposition to the taxpayer's petition for certiorari in *Transport, Trading & Terminal Corp.*, cert. den. 338 U.S. 955, footnote 87, above. See in general the discussion in the text under the caption "Ordinary Dividend in Kind," above.

[94a] A note which is anything but reassuring on this score is struck by the regulation which the Commissioner has proposed under IRC § 346, the new partial liquidation section. Prop. Reg. § 1.346-3.

8. Sale of Stock

When a prospective purchaser of corporate property is considering a counter offer to sell him all the stock, it is important for the stockholder to be able to assure him that, after he has bought the stock, he will not find himself saddled with transferee liability for a tax arising against the corporation as a result of his taking the property out of it via liquidation.

Thus, although this subject is covered more fully elsewhere in this book, it is appropriate at this point to mention that all the recent efforts on the part of the Commissioner to tax the corporation in transactions like this as though it were the seller of the property have failed. The Tax Court has decided each case in favor of the taxpayer.[95]

Furthermore, in the *Cumberland* case the Supreme Court has hinted, in dictum, that it too would decide this issue against the Government.[96]

9. Corporate Contingent Contract

Some prospect of avoiding double taxation is offered by this technique. However, the sale contract's contingent nature is at once an essential to any hope of success for this device and a weakness that limits its usefulness.

It is essential to its success because it is upon the contingent character of the contractual consideration that the corporation must base its argument against the tax assessor.[97] But its weakness lies in the fact that as a rule businessmen like to sell for an amount certain, and tend to shun deals that make the purchase price indefinite or contingent. Only when dealing with certain special types of property (like patents, mining or oil interests, and the like) are they accustomed to accept variable purchase prices (percentage of profits or of receipts). This is a non-tax objection to this technique.

By the same token, this is a potential tax flaw, too. Thus, unless the corporate property that is the subject of the sale falls into the latter category, the trial court will be prone to presume that an unusual contract like this is prompted primarily, if not solely, by tax-avoidance hopes. The damaging effect that such a conclusion still can have upon achieving judicial recognition of a liquidation as genuine already has been discussed.[98] Yet unless such recognition is accorded, the court may well deem that the stockholders, when they ultimately receive payment of the purchase price in some year subsequent to the purported liquidation, are doing so in the capacity of trustees for the corporation [99]—and therefore will compel the stockholders to pay a transferee tax on account of the ordinary income tax thereupon due from the corporation, as well as a capital gains tax upon such gain as they individually may net upon their investment.

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[95] *Steubenville Bridge Company*, 11 T.C. 789 (1948); *Dallas Downtown Investment Company*, 12 T.C. No. 17 (1949). See also *J. T. S. Brown's Son Co.*, footnote 72; *Armored Tank Corporation*, footnote 71, above. Compare *Koppers Coal Co.*, 6 T.C. 1209 (1946), as well as *Prairie Oil and Gas Co.* v. *Motter* (6 Cir. 1933), 66 F. 2d 309; *Commissioner* v. *Ashland Oil & Refining Co.* (6 Cir. 1938), 99 F. 2d 588, 21 AFTR 1168. Compare *H. B. Snively*, 19 T.C. 850 (1953). The basis doctrine flowing from the *Kimbell-Diamond* case (14 T.C. 74, affirmed 187 F. 2d 718, cert. den. 342 U.S. 827), particularly as reinforced by the 1954 Code's § 334, tends to make this technique more acceptable to the purchaser.

[96] After the Supreme Court thus expressed itself in *Cumberland*, the Commissioner, who earlier had stated his non-acquiescence, acquiesced in the *Steubenville* and the *Dallas Downtown* cases, footnote 95, above.

[97] See footnote 9, above.

[98] See discussion in text supported by footnotes 48 and 49, above.

Consequently this particular technique should be used with care. Certainly this is true at the present time, when it has not yet been put to the test in the courts.

10. Conclusion

In the usual gain situation the best way to handle the deal from the seller's viewpoint is by a sale of stock to the purchaser, leaving it to him to get the desired property out of the corporation thereafter. This method should cost the selling stockholders only a single tax.

If the purchaser refuses to accept that type of deal, the next best move usually will be to have the corporation itself sell the property in a fashion which will meet the requirements of § 337.

If neither of these courses is open, then the thing to do is to cause the corporation to initiate a complete liquidation and distribute to the stockholders the property in question; then let them sell the property to the purchaser on their own account. This particular method should be adopted without any cocksure illusions, particularly if the taxpayer is in a hostile circuit. If this method is to succeed (as it can), the entire transaction must be carefully planned and executed. Furthermore if the Commissioner should assert a tax against the corporation, the forum for the litigation should be intelligently selected.

Less than certain though it is that this second method will serve to avoid the double tax, it is better than the remaining method of permitting the corporation itself to make the sale directly. For in the latter case it usually is certain that the double tax will be imposed. (Even the as yet untested "corporate contingent contract" variation is not entitled to full confidence, and at present it is better left to those who either have no alternative or are possessed of a hankering to pioneer.)

In the typical loss situation, however, the picture is reversed, and the preferred technique is to let the corporation, itself, do the selling.

Finally, here is a checklist of what to do in a *gain* situation:

1. Determine whether or not the facts in your case make it practical for the corporation itself to make the sale under the protection of § 337.

2. If for some reason you cannot use § 337, adopt the following course of conduct: Reject forthwith any overtures from the purchaser to the corporation.

a. Have this recorded in writing. A letter from the president of the corporation to the purchaser, simply stating a rejection of the offer, will be in order.

3. Try to get the purchaser to buy the stock.

4. If the purchaser insists on buying the property itself: Distribute first, towards complete liquidation; negotiate afterwards.

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[99] Compare "Addendum" to the original opinion of the Circuit Court in *Fairfield Steamship Co. v. Commissioner,* footnote 61, above.

a. This is relatively practical when you know that there is an active and desirable market for the type of property.

b. This is less practical when the market is sluggish and inactive. (However, in a proper case recourse to § 333 may make this more feasible.)

5. Have the corporate minutes and other records reflect whatever reasons not relating to taxation exist for determining to liquidate.

6. If it is not practical to distribute first, then: Make it a matter of clear record that all negotiations are on behalf of the stockholders alone, and not in any sense for the corporation.

a. Do not mention the sale, as such, in the corporate minutes.

b. Have a letter pass from a representative of the stockholders to the purchaser, stating explicitly that the stockholders are willing to discuss the sale, by them, of specified property that they reasonably expect to get, although they do not presently have title to it.

c. The representative of the stockholders should be someone who is not an officer or director of the corporation.

d. If the representative of the stockholders is himself a stockholder, it is better that he be a minority holder than a controlling holder.

e. Have the instrument appointing the stockholders' representative clearly and unambiguously define his authority, so that it may not be misconstrued as giving him authority to act for the corporation.

f. Do not permit the contract between the stockholders and the purchaser to adopt any arrangements previously made by the purchaser with the corporation respecting the sale.

7. If it is not practical to distribute first: Distribute as long a time as possible before a meeting of the minds is reached.

8. If it is not practical to distribute before a meeting of the minds is reached: Have the corporation formally resolve to dissolve (cause the stockholders and/or directors meetings, resolutions, and records thereof to be strictly according to Hoyle) before making any binding contract or memorandum for the sale.

a. If a meeting of the minds is reached before liquidation and/or formal dissolution resolution, and if the affair has been so handled that it appears likely that it will be viewed by the courts as a corporate (rather than stockholders) deal, consider a "corporate contingent contract" as an alternative to the possibility of abandoning the deal and having to look for another buyer with whom to start all over again.

9. In liquidating:

a. Comply with all the "red tape" required by State law and the corporate bylaws affecting dissolution and liquidation. Be sure the corporation is going to be officially dead.

b. Have the dividend (for example, a certificate of undivided interest in the property) go directly to the individual stockholders. Then they should make their own assignment of their property interest to their representative.

c. The stockholders' representative should continue to be divorced from the corporation. Certainly he should not be the corporation's own statutory liquidating trustee.

d. Have the instrument appointing the representative clearly limit his authority to receiving the property from the stockholders, negotiating for the sale of the property on their behalf, and distributing the proceeds of the sale to them. The representative should not be empowered to discharge any of the obligations due by the corporation.

10. Avoid use of an ordinary dividend type of distribution.
11. Avoid use of a distribution in a "going concern" type of partial liquidation.

NOTE: This checklist represents the conservative approach. Although under certain circumstances it may be possible to deviate from this approach and still manage to achieve immunity from the double tax, any step away from the conservative should be taken with eyes wide open, especially in a dangerous circuit.

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Selling Partnership Interests and Partnership Property

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The enactment of the Internal Revenue Code of 1954 marks a new era in the law of Federal income taxation with respect to partnerships and partners. The new law resolves many of the questions that frequently arose under the Internal Revenue Code of 1939. Most, if not all, of the major areas of litigation under prior law have received attention under the provisions of the new Code, and while unquestionably disagreements between the taxpayer and the government will arise, it may be safely concluded that much of the uncertainty which previously existed will disappear.

This chapter concerns the tax problems and consequences which result from the sale or disposition of partnership interests and the sale or disposition of partnership property.

1. Points to Consider

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2. Basis of Partner's Interest

One of the factors necessary to the determination of the tax consequences of the sale or exchange of an interest in a partnership is the partner's basis for his interest. In most cases the determination of basis will be a relatively simple problem although under certain circumstances the computation may be quite involved. The starting point in determining basis is the manner in which the partner's interest was acquired by him.

a. Interest acquired by contribution. The Internal Revenue Code[1] provides that where a partner's interest in a partnership is acquired by a contribution to the partnership of property (including money), the basis for such interest is the amount of money plus the adjusted basis of the property to the contributing partner at the time of the contribution. This rule may be illustrated as follows: A and B form a partnership, AB, to which A contributes $500 cash and real estate having an adjusted basis to him at that time of $1500. A's basis for his interest in AB is $2000.

Certain adjustments must be made to the partner's basis for his interest to reflect the results of operations as they affect the computation of basis. The partner's basis as determined under the above rule is to be increased by:

1. His further contributions to the partnership;
2. His distributive share of partnership taxable income (including capital gains);
3. His distributive share of any tax exempt income of the partnership;
4. His deductions for depletion to the extent they exceed the basis of his interest in the depletable property; and
5. His proportionate share of any liabilities incurred by the partnership.

The amount arrived at after making the above adjustments is reduced by:

1. The partner's distributive share of losses of the partnership (including capital losses);
2. His share of partnership expenditures which are neither deductible in arriving at net income, nor chargeable to capital;
3. The amount of any money distributed by the partnership to the partner and the amount of the partner's basis [2] for any property other than money distributed to him; and
4. His proportionate share of any partnership liabilities which are discharged.

The result of the above adjustments is the basis of the partner's interest used to determine gain or loss upon the sale or exchange of such interest by the partner.

b. Interest acquired by transfer. The basis of a partnership interest acquired by transfer or in any manner other than by contribution is determined by reference to the provisions of the Code relating to basis rules of general application.[3] Thus, the basis of an interest acquired by purchase would be cost [4] and the basis of an interest acquired by inheritance would be fair market value at the date of death of the partner from whom such interest is inherited.[5] The amount arrived at by the application of these general rules is further adjusted in the manner described in subsection 2a above.

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[1] 1954 IRC §§ 705, 722.

[2] See section 7 of this chapter for rules regarding determination of the partner's basis in partnership property.

[3] 1954 IRC §§ 742, 1011, et seq.; 1939 IRC § 113.

[4] 1954 IRC § 1012; 1939 IRC § 113(a).

[5] 1954 IRC § 1014; 1939 IRC § 113(a)(5).

The rules discussed so far are no different in substance from the rules followed under the law as it existed prior to the passage of the Internal Revenue Code of 1954. The 1939 Code, however, contained no specific provisions for the determination of the basis of a partner's interest, but rather such determination was made in accordance with the general rules relating to basis of property The specific provisions of the 1954 Code reflect a formalization or codification of practices as followed under prior law.

c. Alternative rule. In addition to the above rules for determination of the basis of a partner's interest in a partnership, the Internal Revenue Code of 1954 makes provision for an alternative rule. The statute [6] provides that under regulations to be prescribed by the Secretary or his delegate, the adjusted basis of a partner's interest may be determined by reference to the partner's proportionate share of the adjusted basis of partnership property upon a termination of the partnership. It is contemplated that this alternative rule will provide a simplified method of determining basis in cases of uncomplicated partnerships by attributing to each partner a proportionate share of the total basis of all of the partnership assets. There was no similar provision under prior law, although the result of the alternative rule would, in most cases, be the same as under the rules discussed earlier.

Certain adjustments to the basis arrived at under the alternative rule will be necessary. For example, adjustments would be required to correct any discrepancies in the bases of the various partners resulting from previous transfers of partnership interests, or to take into account the application of special basis rules with respect to partnership assets.[7]

3. Recognition and Character of Gain or Loss

The law [8] provides the general rule that gain or loss upon the sale or exchange of a partnership interest shall be recognized and shall be considered as gain or loss from the sale or exchange of a capital asset. As a starting point, then, an interest in a partnership is considered as a single capital asset.

Prior to the passage of the Internal Revenue Code of 1954, recognition had been given by the Commissioner to the capital asset nature of a partnership interest.[9] Thus, under prior law and current law the entity theory of partnerships is adopted as the general rule.

Under prior law, the Commissioner had originally maintained the position[10] that the sale of a partnership interest constituted the sale of the partner's proportionate interest in specific partnership assets and that the nature of the gains or losses realized should be determined in accordance with the nature of the various partnership assets. The overwhelming majority of the court decisions,[11] however, followed the theory that an interest in a partnership is a capital asset, and that a sale thereof does not constitute the sale of an undivided interest in partnership assets.

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[6] 1954 IRC § 705(b).

[7] Footnote 2, above.

[8] 1954 IRC § 741.

[9] G.C.M. 26379, 1950 C.B. 58.

[10] G.C.M. 10092, XI-1 C.B. 114. See also G.C.M. 20251, 1938-2 C.B. 169.

[11] *Dudley F. Humphrey*, 32 B.T.A. 280 (1935); *Stilgenbaur* v. *Commissioner* (9 Cir. 1940), 117 F. 2d 283, 25 AFTR 966; *McClellan* v. *Commissioner* (2 Cir. 1941), 117 F. 2d 988, 25 AFTR 487; *Commissioner* v. *Shapiro* (6 Cir. 1942), 125 F. 2d 532, 28 AFTR 1079; *Thornley*

Under prior law and current law, there were and are certain exceptions to the capital asset theory of partnership interests.

a. Effect of the nature of the partnership assets. Under prior law the Commissioner has presented various arguments by which he has attempted to establish exceptions to the capital asset theory.

One of the situations in which the Commissioner took a position contrary to the entity-capital asset theory involved the sale of an interest in a partnership in which there were unbilled and uncollected items which would represent ordinary income to the partnership when collected. For example, uncollected fees for services rendered, where the partnership reported income on the cash basis. The Commissioner took the position that, to the extent the proceeds received represented payment for the partner's interest in such receivables, such proceeds should be taxed as ordinary income to the selling partner.

In the case of *Max Swiren,*[12] the Tax Court upheld the Commissioner, holding that what was sold was composed of two elements:

1. The proprietary interest in the partnership, which was recognized as a capital asset, and
2. The right to receive a percentage of the partnership earnings.

The latter element, the Tax Court held, was not a capital asset and the proceeds therefrom were taxable as ordinary income. The Court of Appeals for the Seventh Circuit has since reversed the Tax Court,[13] holding that the interest as a whole was a capital asset without regard to the nature of the underlying assets.

The Tax Court's ruling in the *Swiren* case seems inconsistent with its rulings in previous cases,[14] although it should be remembered that the *Swiren* case came before the Tax Court prior to the issuance of the Commissioner's ruling in 1950[15] recognizing partnership interests as capital assets. The decision of the Tax Court in the recent case of *James M. Tyree,*[16] seems somewhat inconsistent with its decision in the *Swiren* case.

The foregoing discussion points up the uncertainty of the tax consequences arising from the sale of a partnership interest under these circumstances prior to enactment of the 1954 Code.

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v. *Commissioner* (3 Cir. 1945), 147 F. 2d 416, 33 AFTR 684; *United States* v. *Landreth* (5 Cir. 1947), 164 F. 2d 340, 36 AFTR 255; *Commissioner* v. *Lehman* (2 Cir. 1948), 165 F. 2d 383, 36 AFTR 545; cert. den. 334 U.S. 819 (1948); *Commissioner* v. *Gartling's Estate* (9 Cir. 1948), 170 F. 2d 73, 37 AFTR 322; *Commissioner* v. *Smith* (5 Cir. 1949), 173 F. 2d 470, 37 AFTR 1143; cert. den. 338 U.S. 818 (1949); *Long* v. *Commissioner* (5 Cir. 1949), 173 F. 2d 471, 37 AFTR 1144; cert. den. 338 U.S. 818 (1949); *United States* v. *Shapiro* (8 Cir. 1949), 178 F. 2d 459, 38 AFTR 1043; *Swiren* v. *Commissioner* (7 Cir. 1950), 183 F. 2d 656, 39 AFTR 781. But, see the earlier decisions in *City Bank Farmers Trust Co.* v. *United States* (Ct. Cl. 1942), 47 F. Supp. 98, 30 AFTR 136; *Helvering* v. *Smith* (2 Cir. 1937), 90 F. 2d 590, 19 AFTR 889.

[12] *Max Swiren,* par. 49,251 Prentice-Hall Memorandum T.C. (1939)

[13] *Swiren* v. *Commissioner,* Op. Cit., footnote 11, above.

[14] *Swiren* v. *Commissioner,* Op. Cit., footnote 11, above.

[15] Footnote 9, above.

[16] *James M. Tyree,* par. 53,186, Prentice-Hall Memorandum T.C. (1953).

Section 751 of the 1954 Code makes specific provision with regard to the sale of a partnership interest where a portion of the sale price is attributable to unrealized receivables. The statute[17] provides that the money or property, received by a partner in exchange for all or part of his partnership interest, which is attributable to unrealized receivables shall be considered as having been received from the sale or exchange of non-capital assets. Unrealized receivables are defined[18] as including any rights to payment (to the extent not previously includible in income) for, goods delivered or to be delivered (other than capital assets), or services rendered or to be rendered. This provision in the statute requires the result reached in the *Swiren* case by the Tax Court.

In addition to the provision regarding unrealized receivables, the new Code contains a similar provision[19] with respect to the sale of an interest in a partnership where the partnership assets include inventory items which have substantially appreciated in value. Under this provision any proceeds from the sale of a partnership interest attributable to such inventory items will be considered as proceeds received from the sale of non-capital assets. The statute provides a formula defining "inventory items which have appreciated substantially in value."[20] Such items are considered as having appreciated substantially in value if their fair market value exceeds 120 per cent of their adjusted basis to the partnership and such items make up more than 10 per cent of the fair market value of all partnership property other than money.

These provisions were placed in the law to eliminate the use of the so-called "collapsible partnership" device whereby potential ordinary income may be converted into capital gain by virtue of transfers of partnership interests.[21] Under prior law, where the capital asset theory of partnership interests was adopted, presumably a partner could sell his interest, which would include his *pro rata* share of unrealized receivables and appreciated inventory, and realize capital gain on the entire proceeds. It has also been suggested that under prior law all of the partners could simultaneously sell their respective interests, thus realizing capital gain on the entire partnership receivables and inventory.[22] There is at least some authority for treating the sale of the entire partnership as sales of the respective partners' interests rather than as a sale of partnership assets[23] provided the interests as such were sold and not the partnership assets. The new statutory provisions would seem to fairly well eliminate the "collapsible" technique as a workable device.

Another instance in which the nature of the partnership assets affects the tax consequences arising from the sale of an interest in the partnership is where the partnership has elected to report sales on the installment basis. In the recent case of *Rhett W. Woody*,[24] the partnership had elected to report its sales on the installment basis, and when the taxpayer sold his entire interest to the remaining partner, the Commissioner allocated a portion of the selling price to the installment obligations and assessed tax on the gain realized therefrom as ordinary income. The Commissioner's theory was based upon the provisions of the Internal Revenue Code[25] taxing gain upon installment obligations at the time of the disposition of such obligations. The taxpayer relied upon the argument that he disposed of his partnership interest as such and not the underlying assets. However, the Tax Court upheld the Commissioner, distinguishing previous cases on the ground that in this instance there was a specific statutory provision with respect to the treatment of proceeds received upon the disposition of installment obligations. This case seems contrary to the generally accepted rule that the sale of a partnership interest does not constitute a disposition of the partner's undivided interest in partnership assets. However, this is the latest pronouncement on this question and must be treated with due regard by taxpayers in similar circumstances.

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[17] 1954 IRC § 751(a).

[18] 1954 IRC § 751(c).

[19] 1954 IRC §§ 751(a) and (c).

[20] 1954 IRC § 751(d).

[21] See: H. Rept. No. 1337, 83rd Cong. 2d Sess., p. 70.

[22] See: "Theory of the Tax Treatment of the Sale of a Partnership Interest," *Columbia Law Review*, February 1952, Vol. 52, pages 257-264.

[23] *Hatch's Estate* v. *Commissioner* (9 Cir. 1952), 198 F. 2d 26, 42 AFTR 296. But Cf. *Whitney* v. *Commissioner* (2 Cir. 1948), 169 F. 2d 562, 37 AFTR 211, and *Paul W. Trousdale*, 16 T.C. 1056 (1951).

[24] *Rhett W. Woody*, 19 T.C. 350 (1952).

4. Transactions Treated as Sales or Exchanges of Partnership Interests

A typical problem with which partners are frequently concerned is the arrangement to pay a retiring partner for his interest in a partnership which is to be continued by the remaining partners. It is also frequently the case that the remaining partners are unable or do not desire to make an outright purchase of the interest of a retiring partner. A favorite solution to this problem is an arrangement whereby the retiring partner receives fixed payments over a period of years or receives payments representing a percentage of the partnership net income. The tax treatment of such payments is quite often of no little concern to both the recipient and the remaining partners. A similar situation is presented in the case of payments made to the estate of a deceased partner.

Under the law prior to the 1954 Internal Revenue Code, the applicable rules were derived to a great extent from case law rather than from specific statutory provisions. The nature and treatment of such payments was seemingly dependent upon the particular language in the partnership agreement or whether the payments purported to be in exchange for the retiring or deceased partner's interest, without regard to the measure of the amount of such payments.[26]

Section 736 of the Internal Revenue Code of 1954 provides that payments made to the estate of a deceased or to a retired partner shall be considered as payments of such partner's distributive share of partnership earnings, or, if determined without regard to partnership income, as guaranteed payments (for services rendered or for the use of capital). In either event, such payments will ordinarily be taxable as ordinary income to the retired partner or to the deceased partner's estate and deductible by the remaining partners in computing their distributive shares of the partnership profits.

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[25] 1954 IRC § 453(d); 1939 IRC § 44(d). Note that the 1954 Code provision does not differ from prior law insofar as it affects individuals and partnerships.

[26] See, for example, the result obtained in *Hill* v. *Commissioner* (CA-1, 1930), 38 F. 2d 165, 8 AFTR 10152; *Pope* v. *Commissioner* (CA-1, 1930), 39 F. 2d 420, 8 AFTR 10523, and *W. Frank Carter*, 36 B.T.A. 60 (1937). But, Cf. *Carol F. Hall*, 19 T.C. 445 (1952); *Charles R. Whitworth, et al.*, par. 52,353 Prentice-Hall Memorandum T.C. (1952), affirmed (CA-7, 1953), 204 F. 2d 779, 43 AFTR 978, and *Francis J. Clowes*, par. 52,354 Prentice-Hall Memorandum T.C. (1952).

In order to prevent the inequities which would result from the application of this general rule by subjecting the retired partner to ordinary income tax on the portion of such payments as may be attributable to his capital interest in the partnership, section 736(b)[27] provides that, to the extent any payments made in liquidation of the interest of a deceased or retired partner are determined (under regulations of the Secretary or his delegate) to be made in exchange for such interest, the payments are to be treated as distributions by the partnership and will therefore be treated as proceeds from the sale or exchange of such interest.[28] It is intended by this section that, regardless of the measure of the payments made, such payments will be treated, as to both the retiring partner and the remaining partners, as proceeds from the sale or exchange of a partner's interest to the extent attributable thereto, and as ordinary income to the extent of the remainder thereof.

The remaining partners are entitled to no deduction from their distributive shares for the amounts allocable as payment for the capital interest of the retiring or deceased partner.

Section 736(b) also contains special rules providing that no part of the payments allocated to the purchase of the interest of the retired or deceased partner shall include amounts paid for unrealized receivables or goodwill of the partnership. An exception to this provision is made in cases where the partnership agreement provides for a payment with respect to goodwill. It will thus be seen that a retiring partner or the personal representative of a deceased partner will be permitted to treat the disposition of his interest in the same fashion as though such interest had been sold in a single transaction[29] except that, ordinarily he will not be entitled to realize capital gain from the sale of goodwill. Other limitations applicable to the treatment of the proceeds as capital gain are similar to the limitations discussed above in connection with the direct sale of an interest. Any payments which are not attributable to the purchase of his interest are treated as ordinary income.

5. The Importance of Timing

The sale or exchange of an interest in a partnership as well as other transfers of such interest may produce varying tax results depending upon the time such transactions take place.

a. Pyramiding income in year of sale. The sale or exchange of a partnership interest, the merger of two or more partnerships, or the split-up of a partnership may cause the pyramiding or "bunching" of more than twelve months' income in a single taxable year of the selling partner or the remaining partners or all of them. The problem with respect to the selling partner is dealt with in greater detail later in this subsection, therefore we will confine the initial discussion primarily to the effect on the remaining partners.

The problem of "bunching" income arises where the partnership accounting period is different from that of the individual partners. The Code[30] requires that partners report their partnership income for the taxable year of the partnership which ends within or with their own taxable years. It will be observed that if a partnership has a taxable year ending June 30th and its partners all report income on a calendar year basis, any termination of the partnership's fiscal year between June 30th and December 31st would cause two taxable years of the partnership to end within one taxable year of the partners. Thus, if the partnership were terminated, thus closing its taxable year on November 30th, the partners would be subject to tax on seventeen months' income in one calendar year.

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[27] 1954 IRC § 736(b).

[28] See 1954 IRC § 731(a).

[29] See discussion in section 3a above.

Under the law prior to the 1954 Code, the position of the Commissioner regarding the effect on partnership accounting periods of the death or withdrawal of a partner has undergone a complete change. In a very early ruling[31] the Commissioner took the position that the dissolution of a partnership brought about by the death or withdrawal of a partner automatically brought to a close the current taxable year of the partnership. The problem arose primarily in the case of the death of a partner, since, in most instances the dissolution of a partnership by withdrawal of a partner could be controlled. When the question came before the courts, a distinction was drawn between dissolution and termination[32] and the majority of decisions have held that where the partnership is not in fact terminated, the taxable year does not close merely by reason of the dissolution resulting from the death or withdrawal of a partner.[33]

In 1953 the Commissioner, recognizing the viewpoint of the majority decisions, issued Revenue Ruling 144,[34] revoking the earlier ruling,[35] and reversing the position previously taken. Under the new ruling it was held that a change in the membership of the partnership "resulting from the death, withdrawal, substitution, or addition of a partner, or a shift of interest among existing partners" did not "in itself, effect a termination of a partnership for Federal income tax purposes." The ruling held that ordinarily the partnership would be treated as continuing and the annual accounting period of the partnership would remain the same.

To a great extent Revenue Ruling 144 would have relieved the situation with respect to partnerships being dissolved by death, withdrawal or other changes in membership. However, the effect of this ruling was destined to be short lived, since the 1954 Code provides specific rules regarding this subject.

Under the 1954 Code[36] the sale or liquidation of a partner's interest or the death of a partner does not, under the general rule, close the taxable year of the partnership. Thus the result of "bunching" income in one taxable year of the remaining partners is avoided. The new law contains exceptions to this general rule, however, and care must be exercised to make certain that the exceptions are given consideration. Section 706(c) provides that the taxable year of the partnership will close if the partnership is terminated. Section 708(b) provides that a partnership terminates only if no part of the business, financial operation or venture of the partnership continues to be carried on by its partners in a partnership, or if there is a sale or exchange of 50 per cent or more of the total interest in partnership capital and profits.[37] Thus, if a partner owning 50 per cent of the total capital and profits of a partnership should sell his interest or his interest should be liquidated,[38] the partnership taxable year would terminate.

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[30] 1954 IRC § 706; 1939 IRC § 188.

[31] O.D. 228, 1919 C.B. 190.

[32] *Heiner* v. *Mellon*, 304 U.S. 271, 20 AFTR 1263 (1938): *Rossmoore* v. *Anderson* (D.C. S.D., N.Y. 1932), 1 F. Supp. 35, 11 AFTR 1140; Aff'd. (2 Cir. 1934), 67 F. 2d 1009, 13 AFTR 437; *Rossmoore* v. *Commissioner* (2 Cir. 1935), 76 F. 2d 520, 15 AFTR 1178.

[33] *Mary D. Walsh*, 7 T.C. 205 (1946), but cf. *Anne Jacobs*, 7 T.C. 1481 (1946), where the partnership was dissolved and there was no evidence that it was continued after such dissolution for the purpose of liquidation or distribution of partnership assets.

[34] Rev. Rul. 144, 1953-2 C.B. 212.

[35] Footnote 31, above.

[36] 1954 IRC § 706(c).

What has been said above with respect to the closing of the partnership year under the 1954 Code applies to the partnership as such; however, the effect on the selling or retiring partner is quite different. Under the provisions of section 706(c) it is made clear that, with respect to a selling or retiring partner who disposes of his entire interest, the taxable year of the partnership, as to such partner, closes at the time of such sale or liquidation. In the case of a partner who dies, the partnership taxable year with respect to the deceased partner continues to the end of the partnership taxable year in which his death occurs.

It is apparent that the rules with respect to the termination of a partnership and the closing of partnership taxable years will be applied for Federal income tax purposes without regard to local partnership law and without regard to the provisions of partnership agreements except in cases specified. Under prior law the termination of a partnership was governed in many cases by the provisions of the partnership agreement.[39]

In addition to the problem of closing the partnership taxable year by an outright sale or liquidation of a partnership interest, or by the death of a partner, there is also this same problem of "bunching" income where two or more partnerships merge or consolidate or where a partnership is divided into two or more new partnerships. The Internal Revenue Code of 1954 [40] provides special rules in the case of such transactions. Where there is a merger or consolidation of two or more partnerships, the resulting partnership will be considered as a continuation of any merging or consolidating partnership whose members own an interest of more than 50 per cent of the capital and profits of the resulting partnership. Thus the taxable year of the resulting partnership would be that of the firm whose members own more than 50 per cent of the capital and profits[41] of the resulting firm.

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[37] Section 708(b)(1)(B) uses the words, "capital and profits." It should be kept in mind that the "and" denotes the disjunctive, therefore it is necessary that a 50 per cent interest in both capital *and* profits be transferred in order to fall within the meaning of the section.

[38] It should be noted that a disposition by way of gift or a transfer at death will not result in termination even though interests of more than 50 per cent are so transferred. See, *H. Rept. No. 2543, 83rd Cong. 2d Sess., p. 61.*

[39] Rabkin and Johnson, "Death of Partner: partnership continued to end of fiscal year—partners on calendar year basis." *Current Legal Forms,* Vol. 1, pages 87-88. But Cf. *Lowenstein Estate,* 12 T.C. (1949). If the Tax Court follows the logical conclusion of its rule in Lowenstein, partnerships may not be terminated by death where there is an agreement for continuation.

[40] 1954 IRC § 708(b)(2).

[41] Here again, note that the word "and" is used thus making it necessary that the members of an original partnership own a 50 per cent interest in both the capital and the profits of the resulting partnership in order to continue the same fiscal year. It is interesting to note that this requirement makes it possible that neither of two or more merging firms would meet the requirement for continuation, thus the taxable years of both firms would close upon their merger.

Where a single partnership is divided into two or more partnerships all of the resulting partnerships are considered as continuations of the original partnership except where the members of any resulting partnership had an aggregate of less than a 50 per cent interest in the capital and profits of the prior partnership. In such case the partnership taxable year would close as to the resulting partnership.

Under the provisions of section 706(b) of the 1954 Code, a partnership resulting from a merger or consolidation or from a division of a single partnership, which does not qualify as a continuing partnership under the rules discussed above, would not be permitted to adopt a taxable year different from that of all of its principal partners without establishing, to the satisfaction of the Secretary or his delegate, a business purpose for doing so.

b. Treatment of income in year of sale. In addition to the problem of pyramiding or "bunching" income of the members of a partnership in a year in which a partner sells his interest or retires or in which the death of a partner occurs, there is the further problem of the tax treatment of partnership income in the year of such sale, retirement or death. Frequently a partner sells his interest to a new partner or to the remaining partners or they agree to purchase the interest of a deceased partner. In such cases where the purchase price agreed upon is the partner's capital interest plus his share of partnership profits to the date of sale, retirement or death, the question arises as to how such proceeds are to be taxed and to whom. In cases where this question was present, the courts have been divided as to whether the entire amounts received should be treated as proceeds from the sale of a capital asset,[42] or whether the selling partner should be taxed on his share of the income at ordinary income rates and the balance treated as proceeds from the sale of a capital asset.[43] Under prior law it has been suggested that the purchaser of a partnership interest would be taxable on the same portion of the partnership income as the selling partner would have been had he continued to the end of the fiscal year and that to tax both the seller and the purchaser on the same income would produce a double tax for the revenue.[44]

This question has been fairly well resolved by the provisions of the 1954 Code. We have already noted that under the 1954 Code, upon the sale or liquidation of a partner's interest, the partnership taxable year closes with respect to the selling or retiring partner. Section 706(c) further provides that such partner's distributive share of partnership income, gains, losses, etc., for such year shall be determined under regulations, and section 706(a) requires that his distributive share be included in his income in the year in which the partnership taxable year closes. These provisions leave no doubt as to the treatment of income with respect to a selling or retiring partner.

When a partner dies, we have already seen that his taxable year does not close but continues to the end of the regular partnership taxable year. In this case the question arises as to whether the deceased partner's distributive share must be included as income in the decedent's final return or whether it is returnable as income by the deceased partner's estate or successor in interest. By reason of the provision in the statute postponing the closing of the partnership taxable year in case of the death of a partner, it is made clear that the income of such year would not be includible in the decedent's final return but would be includible in the gross income of his estate or that of his successor in interest.[45] Section 753 provides that amounts accrued to the date of death and includible in the gross income of a successor in interest shall be considered as income in respect of a decedent under the provisions of Section 691.[46]

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[42] *Meyer* v. *U.S.* (7 Cir. 1954), 213 F. 2d 278, par. 72,599 Prentice-Hall Fed. 1954.

[43] *LeSage* v. *Commissioner* (5 Cir. 1949), 173 F. 2d 826, 37 AFTR 1233; *Louis Karsch*, 8 T.C. 1327 (1947).

[44] Valentine Brookes, "The Strange Nature of the Partnership under the Income Tax Law," 5 *Tax Law Review*, page 35.

6. The Holding Period

For the purposes of determining the extent to which gain or loss on the sale of a partnership interest is taxable, it is necessary to determine the period during which the seller held the asset sold. In the light of the Commissioner's recognition of a partnership interest as a capital asset and in light of the characterization of such interests as capital assets under the 1954 Code, there seems no doubt that the holding period for this purpose begins with the date of acquisition by the partner of his interest, and terminates as of the date of sale or transfer.[47]

Initially the Commissioner, adhering to his theory that a partnership interest represented an undivided interest in partnership assets, took the position that the holding period for a partnership interest was also divisible into the respective holding periods for each of the partnership assets. This theory was upheld by the Tax Court in an early case[48] on the authority of *Helvering* v. *Smith*.[49] The *Smith* case is generally believed to have been overruled by *Commissioner* v. *Lehman*,[50] which adopted the rule that a partnership interest has a holding period separate and distinct from that of the various partnership assets. Thus, there appears to be no further objection to the separate holding period under either the new law or under prior law.

7. Selling Partnership Property

When the sale of partnership property is contemplated, the principal question is whether the property should be sold by the partnership or distributed to the individual partners and sold by them. The basic considerations involved in determining which way the sale should be accomplished are (1) the basis to be used in determining the gain or loss on the sale and (2) the nature of the gain or loss to be realized.

Basis of partnership property. In order that the complicated basis provisions of the 1954 Code may be more readily understood, it is desirable to discuss separately the questions of basis as to the partnership and as to the partners.

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[45] See Senate Report No. 1622, 83rd Congress, 2d Session, page 386.

[46] 1954 IRC §§ 753, 691; 1939 IRC § 126. With respect to capital payments for the decedent's interest, section 753 is applicable only to unrealized receivables accrued to the date of death and is inapplicable to any part of the value of inventory items as of the date of death.

[47] 1954 IRC § 1223; 1939 IRC § 117(h).

[48] *City Bank Farmers Trust Co.* v. *United States,* Op. Cit., footnote 11, above.

[49] Op. Cit., footnote 11, above.

[50] Op. Cit., footnote 11, above.

a. Partnership's basis. The general provisions regarding the basis of property to the partnership are relatively simple. Property which is contributed to the partnership has as its basis to the partnership the adjusted basis which such property had in the hands of the contributing partner at the time the property was contributed.[51] The basis of property which is purchased by the partnership or acquired in an exchange is determined under the general rules governing the determination of the basis of property.[52]

In addition to the general basis provisions, the new law provides certain special adjustments to the basis of partnership property. These special adjustments arise as a result of the distribution of property by the partnership to a partner. In order to qualify for the special adjustments, however, the partnership is required to elect to make such adjustments.[53] The election is to be made in accordance with regulations to be prescribed.

If the partnership does elect to make the special adjustments and partnership property is distributed to a partner, the adjusted basis of the partnership property remaining after such distribution is then adjusted upward[54] by the following amounts:

1. Any gain recognized to the distributee as a result of his having received cash in excess of the basis of his partnership interest, and
2. Any amount by which the adjusted basis to the partnership of the property distributed, immediately before distribution, exceeds the basis at which the distributee takes the property.[55]

Similarly, if the election is made and any distribution is made in liquidation of a partner's interest, the adjusted basis of the remaining partnership property is adjusted downward[56] by the following amounts:

1. The amount by which the distributee's basis for his partnership interest exceeds the sum of (a) any cash received, and (b) his basis for any unrealized receivables or appreciated inventory items received, and
2. Any amount by which the adjusted basis of the distributed property to the distributee exceeds the adjusted basis of such property to the partnership immediately before the distribution.

It will be noted that downward adjustments to the remaining partnership property are made only in cases where the distribution is in liquidation of a partner's interest whereas upward adjustments may occur in any case where cash is distributed or the distributee takes the distributed property at a substituted basis.

To illustrate the manner in which these adjustments would be applied, assume that the ABC partnership balance sheet is as follows:

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[51] 1954 IRC § 723; 1939 IRC § 113(a)(13).

[52] 1954 IRC §§ 1011 et. seq.; 1939 IRC § 113.

[53] 1954 IRC § 754. It is to be noted that the election applies to all distributions of property and transfers of partnership interests in the year of election and all subsequent years unless revoked in accordance with regulations.

[54] 1954 IRC § 734(b)(1).

[55] The latter adjustment is applicable only in cases where the property has a substituted basis in the hands of the distributee by reason of the limitation in 1954 IRC § 732(a)(2) or by reason of a distribution in liquidation of a partner's interest.

[56] 1954 IRC § 734(b)(2).

ASSETS			LIABILITIES & CAPITAL		
	Adjusted Basis	Market Value		Adjusted Basis	Market Value
Cash	$1000	$1000	Capital—		
Property X	2000	3000	A	$3000	$3000
Property Y	3000	3000	B	3000	3000
Property Z	3000	2000	C	3000	3000
	$9000	$9000		$9000	$9000

Assume, also, that none of the property is unrealized receivables or inventory items. If A's interest is liquidated and the partnership transfers property X to A for his interest, A's basis for the property is $3000.[57] Neither the partnership nor A realizes any gain or loss on the distribution. Under the special basis adjustment provisions, however, if ABC has elected to make the adjustments, the basis of the remaining assets of the partnership after distribution of property X would be reduced in the amount of $1000. In the same circumstances if the partnership distributed $1000 in cash and property Z to A, the basis of the remaining assets would be increased in the amount of $1000.

In the above example, if the election to make the special basis adjustments has not been made by the partnership, no adjustment would be made to the partnership's basis for the remaining assets.

b. Partners' bases. Under the law prior to the enactment of the 1954 Code[58] a partner's basis for property of the partnership which was distributed in kind to him was "such part of the basis in his hands of his partnership interest as is properly allocable to such property." The regulations[59] applicable to prior law shed no further light on the meaning of the words "properly allocable" since the regulations merely restate the statutory language.

It has been suggested that the words "properly allocable" should be construed as meaning that the partnership basis of distributed property should be carried over to the partner receiving such property.[60] However, the Internal Revenue Service has applied the rule that the basis of distributed property to the partner is determined by allocating the basis of the partner's interest in the partnership to the distributed property in proportion to the fair market value of all partnership property at the time of distribution.[61] Under this theory the resulting basis of distributed property in the hands of a partner could vary greatly depending upon the appreciation or depreciation in market value of the distributed property as compared to the market value of other partnership property. The basis of such property to the partnership has no real relevancy to the basis in the hands of the distributee partner.[62]

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[57] 1954 IRC § 732(b).

[58] 1939 IRC § 113(a)(13).

[59] Reg. 118, § 39.113(a)(13)-2.

[60] Rabkin and Johnson, "The Partnership under the Federal Tax Laws," 55 *Harvard Law Review* 909 (1942), pages 920-933.

[61] I.T. 2010, III-1 C.B. 46; G.C.M. 20251, 1938-2 C.B. 169.

An attempt has been made in the Internal Revenue Code of 1954 to apply some logical rules to the determination of the basis of distributed property to the partner receiving such property. The new Code distinguishes distributions which are not in liquidation of the partnership from those which are in liquidation.

The new law[63] provides that the partner's basis of distributed property (except money), which is distributed other than in liquidation of the partner's interest, is the adjusted basis of such property to the partnership immediately before the distribution. The distributee partner's basis, however, may not exceed the adjusted basis of such partner's interest in the partnership reduced by any money distributed to the partner in the same transaction. Thus, the carry-over basis theory is adopted in the case of nonliquidating distributions, limited to a maximum of the partner's basis for his partnership interest.

With regard to property (except money) distributed to a partner in liquidation of the partner's interest, the new Code[64] provides that the partner's basis for such distributed property is an amount equal to the adjusted basis of his partnership interest reduced by any money distributed to him in the same transaction.

To avoid at least part of the questions which arose under the prior law with respect to allocation of the basis of a partner's interest to the property distributed to him, the 1954 law[65] contains special rules for the allocation of the basis of the partner's interest to property received in distribution. These special rules apply in each case where the basis of the distributed property is determined by reference to the basis of the partner's interest, whether under the limitation provided in the case of non-liquidating distributions or under the general rule provided in the case of distributions in liquidation of the partner's interest. Under either of these circumstances, the basis of the partner's interest is to be allocated first to any unrealized receivables and inventory items[66] received by the partner to the extent of the partnership's basis for such property. If the basis of the partner's interest is less than the sum of the partnership's basis for such property then the allocation is to be made in proportion to the respective bases of such property. Any part of the basis of the partner's interest which is not absorbed by the allocation to unrealized receivables and inventory items is to be allocated to the remainder of the properties distributed to the partner in proportion to the respective bases of the partnership of such remaining properties.

It will be observed that under the basis provisions of the new law, the possibilities that abnormal basis figures will be obtained are greatly reduced since whenever allocation is required it is made by reference to the partnership's basis for the property involved rather than to market value.

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[62] By way of illustration, the basis of distributed property to the distributee partner would vary as between a distribution which includes cash and other assets whose market value has not changed, and one which does not include such other assets. For an interesting discussion of the various aspects of this problem, see: Schlesinger, M. R., "Caveat Reiterated: Planning Partnership Liquidation to Avoid Risk of Taxable Gain," 27 *Taxes*, page 731 (August 1949).

[63] 1954 IRC § 732(a).

[64] 1954 IRC § 732(b).

[65] 1954 IRC § 732(c).

[66] For a discussion of what constitutes unrealized receivables and inventory items see section 3a of this chapter.

Generally speaking, except in cases where the basis of distributed property is determined by allocation of the basis of the partner's interest thereto, the taxable gain or loss, whether the property be sold by the partnership or by the partners, would be the same. It must be remembered, however, that if property is distributed to a partner in liquidation of his interest, either in whole or in part, the distribution will itself be considered as a sale or exchange between the partnership and the distributee.[67]

The basis rules discussed above will be applicable in the great majority of the transactions, however, certain special adjustments are made to a partner's basis for property where property is distributed to him or where he acquires his interest by transfer or by devise, bequest or inheritance.[68]

Where the partnership has made the election as prescribed by section 754 of the new Code, and an interest in the partnership is transferred by sale or exchange or upon the death of a partner,[69] then the adjusted basis of the partnership property is:

1. Increased by the excess of the new partner's basis for his partnership interest over his proportionate share of the adjusted basis of the partnership property, or
2. Decreased by the excess of the new partner's proportionate share of the adjusted basis of the partnership property over his basis for his partnership interest.

It is essential to understand, however, that these adjustments apply only with respect to the transferee partner and not to the other partners.

To illustrate the effect of the elective special basis adjustments, assume that the AB partnership has cash in the amount of $1000 and other capital property X worth $1000 but having an adjusted basis of $500. Assume also that A and B each have a 50 per cent interest in capital and profits of the partnership. If A sells his interest to C for $1000 and the permissive election is in effect,[70] a special adjustment would be made increasing the basis of property X as to C in the amount of $250. (C's basis for his interest—$1000 minus his proportionate share of the adjusted basis of the partnership property—50 per cent of $1500 or $750.) Thereafter if property X is sold for $1200 the partnership realizes a gain of $700 or a gain of $350 to each B and C; however, C's taxable gain is reduced by the special adjustment of $250 leaving only $100 as C's taxable gain.[71]

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[67] 1954 IRC § 751(b).

[68] See section 7(a)(1) of this chapter.

[69] 1954 IRC § 743(b).

[70] If property is distributed to a transferee partner within 2 years after he acquires his interest he is permitted to elect the special basis adjustments under 1954 IRC § 732(d) even though the partnership has made no election under section 754.

[71] If property X had been contributed by A when his basis was $500 and an agreement between A and B (1954 IRC § 704(c)(2)) had provided that A would bear all of the precontribution appreciation of the property ($500), then when C purchased A's interest for $1000 he acquired A's share of the partnership assets or $500. C's special adjustment would then be $500. If property X is then sold for $1200, under the agreement B's gain would be $100 and C's gain would be $600; (the precontribution appreciation of $500 would be entirely allocable to C under the agreement and the balance of the gain of $200 would be allocable 50 per cent to each B and C), however, C's special adjustment of $500 reduces his taxable gain to $100. B's gain remains the same.

If the special adjustments referred to above are not elected, the partnership and the partners would compute gains and losses in accordance with their profit and loss ratios or in accordance with any special agreement the partners may have entered into with respect to contributed property.[72]

The new law provides certain special rules and exceptions regarding the applicability of the special basis adjustments. As has previously been pointed out, the special adjustments are not to be made unless the partnership has made the election provided for in section 754. However, in the case of a partner who has acquired his interest by transfer, inheritance, bequest or devise, and to whom property is distributed within 2 years after such transfer, the transferee partner may elect to make the special adjustments as discussed above.[73] The permissive election by the transferee partner is to be made in accordance with regulations to be prescribed by the Secretary or his delegate. Notwithstanding the partner's election or failure to elect, the law also provides that the Secretary or his delegate may require that the adjustments be made, if at the time of the transfer, the fair market value of all partnership property (except money) exceeds 110 per cent of its adjusted basis to the partnership.[74]

8. Nature of Property to be Sold

The nature of the partnership property to be sold has a direct bearing on the manner in which the gain or loss is to be taxed; that is, whether the gain or loss is to be treated as a capital gain or loss or an ordinary gain or loss.

Generally speaking, under both the 1939 Code and under the 1954 Code, ordinary gain or loss is realized unless the asset sold is capital in nature or is to be treated as a capital asset for the purposes of taxing gain or loss.[75]

Under the law prior to 1954, because of the nearly universal acceptance of the theory that a partnership interest constituted a capital asset, it was considered by some that all of the assets of a partnership, both capital and noncapital could be disposed of by a simultaneous sale of all of the partnership interests by the respective partners, and the entire gain thereon would be treated as capital gain.[76]

Under the Internal Revenue Code of 1954, however, the practicality of the use of such techniques as the "collapsible partnership" and distribution of noncapital assets to individual partners prior to the sale thereof in order to secure capital gain treatment thereon has been substantially eliminated. Under the new law,[77] the distribution of assets to a partner in liquidation of his partnership interest is itself a taxable transaction, and in addition the new Code also provides that the gain or loss upon the disposition by the distributee of unrealized receivables or appreciated inventory items received by him from the partnership is to be treated as a noncapital transaction.[78]

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[72] 1954 IRC § 704(c). It should be noted that as to the special adjustments discussed in this subsection, 1954 IRC § 755 provides that such adjustments are to be made in such manner as to reduce the difference between the market value and the adjusted basis of partnership properties or in such other manner as may be prescribed by regulations.

[73] This has reference only to the adjustments made for the difference between the transferee's basis for his interest and his proportionate share of the adjusted basis of the partnership assets.

[74] 1954 IRC § 743(b).

[75] 1954 IRC § 1231; 1939 IRC § 117(j).

[76] It has been suggested that through the sale of partnership interests as distinguished from partnership property, capital gain could be realized upon inventory as well as other assets which have appreciated in value. This device, denominated the "collapsible partnership" has been discussed in section 3a of this chapter.

[77] 1954 IRC § 751.

9. The Holding Period

The holding period of partnership assets by the partnership is determined under the general provisions of the law relating to the determination of the holding period of property.[79]

With respect to the holding period of property distributed by the partnership to a partner, under prior law it is believed that the period during which the partnership held the property prior to distribution could be tacked onto the period during which the individual held the same property thereafter.[80] The 1954 law provides specifically that the partnership holding period may be included.[81] Thus, there seems no question but that the tacking would be permitted under either the new law or the prior law.

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[78] 1954 IRC § 735.

[79] 1954 IRC § 1223; 1939 IRC § 117.

[80] 1939 IRC § 117(h)(1). Presumably under section 117(h)(2) if the property had been originally contributed by a partner to the partnership, the period during which the property had been held by the contributing partner would be added to the holding period of the partnership.

[81] 1954 IRC § 735(b).

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Sales by a Fiduciary

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1. Points to Consider

Section
What type of fiduciary made the sale? 2
How is the fiduciary taxed? 3
Did the fiduciary sell a capital asset? 4
Did the fiduciary sell business property at a gain or loss? 4
What was the basis of the property sold? 5
Did a gain or loss result? 5
How should a capital gain be handled? 6
How should a capital loss be handled? 7
How should a capital gain be reported? 8

2. What is a Fiduciary?

The Internal Revenue Code of 1954 made many changes in the provisions relating to the income taxation of estates and trusts. However, it retained the basic "conduit" theory of taxing distributions contained in the 1939 Code. Its many amendments did much to clarify areas of doubt which have plagued the practitioner for years. Particularly is this true of sales by fiduciaries.

Fiduciaries for estates of decedents and trusts are considered separate legal entities subject to taxation and are covered by Section 641 through Section 668 of the 1954 Code. Much of this material was previously contained in Section 161 through 163 of the 1939 Code.[1] Thus, the administrator or executor of an estate and the trustee of a trust is covered by these sections.

However, these are not the only types of fiduciary relationships. There are many others. "Fiduciary" also means guardian, receiver, conservator or anyone acting in a fiduciary capacity.[2] Not all fiduciaries, however, are taxed as are executors, administrators or trustees. Thus:

1. While a guardian is a fiduciary, the estate of his ward is not a taxable entity. The return is made for the ward.[3]

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[1] Reg. 118, § 39.161-1(b).
[2] 1954 IRC § 7701(a)(6); 1939 IRC § 3797(a)(6).
[3] Reg. 118, § 39.161-1(a).

2. Receivers, trustees in dissolution, trustees in bankruptcy, assignees, etc., while fiduciaries, do not file fiduciary returns, but file a return for the taxpayer for whom they act.[4]

3. While there are certain fiduciary aspects in the agency relationship, agents do not file fiduciary returns.[5]

The problems to be considered in this chapter are those of fiduciaries of decedents' estates or of trusts. They arise because of the separate entity treatment of estates and trusts. Fiduciaries not regarded as taxable entities do not present such problems.

3. How Fiduciaries are Taxed

The theory of the Internal Revenue Code is to tax the income of fiduciaries to someone, but to tax it only once, either in the hands of the fiduciary or his distributee. This is the rationale behind the Code sections imposing the income tax upon estates or trusts.

Distributable net income. The 1954 Code has gone a long way in clarifying this rationale by the addition of Section 643. This section defines certain terms contained in the operative, taxing sections of the Code. The most significant definition is that of "distributable net income." This definition serves the general purpose of limiting the deductions allowable the fiduciary for its distributions and of determining how much of the distribution is taxed to the beneficiary.

In effect, this definition gives statutory expression to the principle underlying the taxation of estates and trusts, i.e., that these separate taxable entities are only conduits through which the income flows to the beneficiaries, except where such income is to be accumulated by the estate or trust for future distribution. In addition, the distributable net income concept determines the character of the amounts distributed to the beneficiary.

To arrive at distributable net income, Section 643(a) provides that the following adjustments must be made to the taxable income of the fiduciary:

1. No deduction is taken for distributions;
2. No deduction is taken for the personal exemption;
3. Capital gains and losses are excluded where allocated to corpus but included when they are actually distributed in the taxable year;
4. In the case of trusts which distribute income only, extraordinary dividends and taxable stock dividends are excluded where the fiduciary allocates them to principal;
5. Tax exempt interest is included;
6. Foreign income is included; and
7. Dividends which are excluded from gross income by Section 116 are included.

When these adjustments have been made to the taxable income of the fiduciary, it is then ready to apply the taxing provisions of the new Code. So, too, the beneficiaries' tax liability may be computed against the backdrop of this concept.

Gross income of fiduciaries. Section 641 (1939 IRC § 161) imposes the same tax upon estates and trusts as is imposed upon individuals.[6] Thus, there are covered:

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[4] Reg. 118, § 39.52-2.

[5] *E.g.* O.D. 425, 2 C.B. 498.

1. Income accumulated in trust for the benefit of unborn persons.[7]
2. Income accumulated in trust for the benefit of unascertained persons.[8]
3. Income accumulated in trust for the benefit of persons with contingent interests.[9]
4. Income accumulated or held for future distribution under the terms of a will or trust.[10]
5. Income which is to be distributed currently by the fiduciary to beneficiaries.[11]
6. Income collected by the guardian of an infant which is to be held or distributed as the court may direct.[12]
7. Income received by estates of deceased persons during the period of administration or settlement of the estate.[13]
8. Income which in the discretion of the fiduciary may be either distributed to the beneficiaries or accumulated.[14]

Net income of fiduciaries. Like other phases of income taxation, the tax imposed on a trust or estate is not levied on its gross income. Net income measures its incidence.[15] That is computed in the same manner as in the case of individuals,[16] with the following pertinent exceptions:

1. There is no limit upon the deductions for charitable contributions provided:

   (a) The contributions for the taxable year are paid or permanently set aside to a charity pursuant to the terms of the will or deed creating the trust;[17]
   (b) The income distributed is not unrelated business income as defined in Section 681(a) of the 1954 Code (1939 IRC § 162(g)(1)), or the fiduciary does not engage in transactions prohibited by Section 681(b)(2) of the new Code (1939 IRC § 162(g)); and
   (c) Due adjustment is made for the long-term capital gain deduction of Section 1202 of the 1954 Code (1939 IRC § 23(ee)).

2. Where a trust, by its terms, is obliged to distribute all of its income and only its income currently for non-charitable purposes, a deduction is allowed for that distribution.[18]
3. Where an estate or trust may accumulate income or distribute principal for non-charitable purposes, a deduction is allowed for any amount of income for such year required to be distributed currently and for any other amounts properly paid or credited or required to be distributed for the taxable year.[19]

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[6] 1954 IRC § 641(b); 1939 IRC § 161(b).
[7] 1954 IRC § 641(a)(1); 1939 IRC § 161(a)(1).
[8] Footnote 7, above.
[9] *Ibid.*
[10] *Ibid.*
[11] 1954 IRC § 641(a)(2); 1939 IRC § 161(a)(2).
[12] Footnote 11, above.
[13] 1954 IRC § 641(a)(3); 1939 IRC § 161(a)(3).
[14] 1954 IRC § 641(a)(4); 1939 IRC § 161(a)(3).
[15] 1954 IRC § 641(b); 1939 IRC § 161(b).
[16] 1954 IRC § 641(b); 1939 IRC § 162.
[17] 1954 IRC § 642(c); 1939 IRC § 162(a).
[18] 1954 IRC § 651(a); 1939 IRC § 162(b).
[19] 1954 IRC § 661(a); 1939 IRC § 162(c).

The deductions allowed under (2) or (3) above may not, in any event, exceed the "distributable net income" of the estate or trust.[20]

4. An estate or trust is not permitted the standard deduction.[21]

5. An estate is allowed a $600 deduction as a personal exemption; a trust required to distribute all of its income currently, $300; and other trusts, $100.[22]

6. Other deductions which may be allowable include the net operating loss deduction,[23] depreciation and depletion deductions,[24] and deductions for the amortization of emergency or grain storage facilities.[25]

Where the estate or trust, on termination, has operating loss carryovers, capital loss carryovers or other deductions in excess of gross income, they may be passed along and used by the beneficiaries.[26] Credits against the tax are allowed for partially tax-exempt interest,[27] foreign taxes[28] and dividends received.[29]

Taxation of fiduciary distributees. Where a trust is entitled to a deduction for income distributed currently, the recipients must include this distribution in computing their taxable income.[30] Likewise, with estates and trusts, amounts of income properly paid or credited to any legatee, heir or beneficiary must be included by him in his taxable income.[31]

Amounts distributable out of income or corpus. Situations may arise where an amount paid, credited or required to be distributed need not be distributed from income. It can be paid or credited out of corpus. Nonetheless, it is considered a distribution of income if the distributions from corpus did not exceed the income available for distribution.[32] If the principal distributions exceed available income, then the recipient is considered as having received income in an amount which bears the same ratio to distributable income as the principal distributed bears to the total distribution.[33] Since gifts, bequests, devises or inheritances are not ordinarily considered income, this rule would not be applicable to them unless, by the terms of the dispositive instrument, they were to be paid, distributed or credited at intervals in excess of three.[34]

4. Types of Sales by Fiduciaries

Sales by a fiduciary fall into three categories:

1. Sales of capital assets.

All property of a fiduciary is a capital asset[35] unless it is:

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[20] 1954 IRC § 643.
[21] 1954 IRC § 142(b)(4); 1939 IRC § 162(c).
[22] 1954 IRC § 642(b); 1939 IRC § 162(c).
[23] 1954 IRC § 642(d).
[24] 1954 IRC § 642(e).
[25] 1954 IRC § 642(f).
[26] 1954 IRC § 642(h).
[27] 1954 IRC § 642(a)(1).
[28] 1954 IRC § 642(a)(2).
[29] 1954 IRC § 642(a)(3).
[30] 1954 IRC § 652(a); 1939 IRC § 162(b).
[31] 1954 IRC § 662(a); 1939 IRC § 162(c).
[32] 1954 IRC § 662(a); 1939 IRC § 162(d).
[33] 1954 IRC § 662(a)(1); 1939 IRC § 162(d)(1).
[34] 1954 IRC § 663(a)(1); 1939 IRC § 162(d)(1).
[35] 1954 IRC § 1221; 1939 IRC § 117(a)(1).

(a) Stock in trade;

(b) Inventory property;

(c) Property held primarily for sale to customers in the ordinary course of trade or business;[36]

(d) Depreciable property used in trade or business;[37]

(e) Real property used in trade or business;[38]

(f) A copyright, a literary, musical or artistic composition (but not a patent), if the basis of such property in the fiduciary's hands is determined by reference to the basis of such property in the hands of its creator;[39]

(g) Business accounts or notes receivable;[40] and

(h) Governmental obligations issued on or after March 1, 1941 on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.[41]

2. Sales of depreciable property used in trade or business or real property used in trade or business, the gain from which may be treated as long-term capital gains.[42]

3. Sales of stock-in-trade, inventory items or property held for sale to customers in the ordinary course of trade or business.

When a capital asset is disposed of, capital gain or loss limitations will apply. Sales of depreciable or real property used in trade or business and held for six months or more may receive capital asset treatment if a gain results but are treated as non-capital assets for loss purposes. Sales of stock-in-trade, trade accounts, inventory items or property held for sale to customers in the ordinary course of trade or business will result in ordinary gains or losses, as the case may be.

5. Basis in Fiduciary's Hands

The basis of property in the hands of a fiduciary is its cost,[43] with the following exceptions:

1. If the property was acquired by bequest, devise or inheritance, or by a decedent's estate from a decedent, the basis is fair market value on the date of the decedent's death.[44] If the estate elects to value the property of the estate for estate tax purposes on the optional valuation date provided by Section 2032 of the 1954 Code (1939 IRC § 811(j)) basis is the value on such date.[45]

2. Where property is transferred to a living trust, income to the grantor for life with a right in him to revoke, the basis of such property after the grantor's death is its value at his death and not at the time of the transfer in trust.[46]

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[36] 1954 IRC § 1221(1); 1939 IRC § 117(a)(1)(A).
[37] 1954 IRC § 1221(2); 1939 IRC § 117(a)(1)(B).
[38] Footnote 37, above.
[39] 1954 IRC §1221(3); 1939 IRC § 117(a)(1)(C)(ii).
[40] 1954 IRC § 1221(4).
[41] 1954 IRC § 1221(5); 1939 IRC § 117(a)(1)(D).
[42] 1954 IRC § 1231(a); 1939 IRC § 117(j).
[43] 1954 IRC § 1012; 1939 IRC § 113(a).
[44] 1954 IRC § 1014(a); 1939 IRC § 113(a)(5).
[45] Footnote 44, above.
[46] 1954 IRC § 1014(b)(2); 1939 IRC § 113(a)(5).

3. The basis of property passing under a general testamentary power of appointment is its value on the date of death of the person exercising the power.[47]

4. If property was acquired by gift, in trust or otherwise, the basis for determining gain is the same as it would be in the hands of the donor or the last person to acquire the property other than by gift.[48] The basis for determining loss, however, is the fair market value of the property at the time of the gift or its basis in the hands of the last person to acquire it other than by gift, whichever results in a lesser loss.[49]

5. If property is transferred in trust, other than by a gift, bequest or devise in trust, its basis is the same as it would be in the hands of the grantor, increased by the amount of any gain recognized on the transfer or reduced by the amount of any loss thereon.[50]

6. Generally speaking, property acquired in a tax-free exchange under applicable code sections takes the basis of the property transferred in the exchange.[51]

7. Property acquired before March 1, 1913 takes as basis its fair market value on that date or its adjusted basis at that time, whichever is greater.[52]

6. How to Handle Capital Gains

From the standpoint of trust and estate accounting under the substantive law principles governing these fields, gain on the sale or exchange of any part of the trust principal is ordinarily treated as a principal accretion distributable with the principal.[53] However, the will or trust indenture may provide that income beneficiaries receive distributions which would otherwise be retained in the trust as principal.[54]

Under the statutory scheme for taxing trusts and estates, income distributed currently to legatees, heirs or beneficiaries, income which becomes payable to them, or income properly paid or credited to them is taxable to the distributee and deductible by the estate or trust.[55] Absent a provision in the will or trust instrument, if local law requires that capital gains inure to principal, there is nothing to be paid, credited or distributed to the beneficiary. Accordingly, the trust or estate should report the capital gain as its income, without any deduction for distribution.[56]

When, however, capital gain is paid, credited or required to be distributed to a beneficiary during the taxable year it is treated as an income distribution.[57] In other words, in this situation the section is to be applied without reference to local law and its characterization of capital gains. Accordingly, when a fiduciary realizes capital gain in a year of distribution, it is taxable to the beneficiary and deductible by the fiduciary.[58]

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[47] 1954 IRC § 1014(b)(4); 1939 IRC § 113(a)(5).

[48] 1954 IRC § 1015(a); 1939 IRC § 113(a)(2).

[49] Footnote 48, above.

[50] 1954 IRC § 1015(b); 1939 IRC § 113(a)(3).

[51] 1954 IRC § 1031(d); 1939 IRC § 113(a)(6).

[52] 1954 IRC § 1053; 1939 IRC § 113(a)(14).

[53] Austin W. Scott, *The Law of Trusts*, Vol. 2, p. 1259, Boston: Little, Brown and Company, 1939; Chester J. Dodge and John F. Sullivan, *Estate Administration and Accounting*, p. 464, New York, Clark Boardman Company Ltd., 1940.

[54] See Scott, *op. cit*, footnote 53, above, at p. 1274.

[55] Footnotes 30 and 31, above.

[56] 1954 IRC § 643(a)(3).

[57] Footnote 56, above.

As a result, capital gains of a fiduciary which are not distributed or required to be distributed in the year of receipt are taxed to the fiduciary without the benefit of a deduction for distribution. A later distribution of those capital gains would neither entitle the fiduciary to a deduction nor require the beneficiary to pick the distribution up as income.[59] However, if capital gains are realized and during the same year a principal distribution is made, whether it be a final distribution or one of a series made at intervals, the estate would be entitled to a deduction and the beneficiary would be required to pay a tax under Section 643(a)(3).

7. How to Handle Capital Losses

General principles of trust and estate law require that capital losses be charged to corpus.[60] Of course, the terms of the will or trust, or, for that matter, provisions of local law, may dictate a contrary result.[61]

Under the scheme for the tax treatment of capital losses, they are first charged against capital gains and are then deductible against net income up to $1000.[62] Excess, unused losses may be carried over in succeeding years, first to offset capital gains for those years and, next, to be applied against net income up to $1000.[63]

However, even with these limitations, there are benefits to be derived by an estate or trust from capital losses if they can be used judiciously. A serious problem exists in this regard where local laws or where the terms of the trust instrument require that capital losses be charged to corpus. These losses are then not properly chargeable against income so as to reduce the distributive shares of the beneficiaries. They affect them only indirectly by reducing income-producing potentialities.

A trust or estate is an individual for tax purposes and, under Section 643(a)(3) of the 1954 Code, it alone is entitled to its deductions: to reduce distributable income by offsetting capital losses is, in effect, to pass the deduction along to the beneficiaries. Furthermore, Code Section 273 provides that no trust deduction may be taken by a beneficiary for shrinkage in the value of his interest due to lapse of time, or for any other deduction of a trust except depreciation or depletion.

This means that where the estate or trust sustains a capital loss, and, under local law or the terms of the trust instrument, it is not to be made up from income, the loss is not deductible in computing the income distributable.[64] However, either local law or the terms of the instrument itself may indicate an intent that corpus not be impaired. Then, distributable income may properly be reduced by first charging against it the capital losses of the fiduciary.[65]

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[58] Footnote 56, above.

[59] 1954 IRC § 662(a); 1939 IRC § 162(d)(2).

[60] Footnote 53, above.

[61] Footnote 54, above.

[62] 1954 IRC § 1211(b); 1939 IRC § 117(d)(2).

[63] 1954 IRC § 1212; 1939 IRC § 117(e)(1).

[64] Footnote 56, above.

[65] Footnote 56, above.

8. How to Report Capital Gains

Under the 1951 Amendments to the Code, 100 per cent of all gains and losses are taken into account. However, if net long-term gain exceeds the net short-term capital loss, 50 per cent of such excess is allowable as a deduction under Section 1202 of the 1954 Code.

This section causes no particular problem when the capital gains are attributable to the principal of the trust. If there is an excess of net long-term capital gains over net short-term capital losses (based on a separate computation of each), 50 per cent of such excess constitutes an allowable deduction.

However, suppose the capital gains are distributable and taxable to the beneficiaries. This means a deduction for the estate or trust to the extent of the distribution. To allow it also a long-term capital gain deduction would mean a double deduction for part of the capital gains distribution. To circumvent this, the statute provides that any long-term gains currently available for distribution are excluded from the fiduciary's computation of its deduction for capital gains.[66]

The same problem exists where the trust or estate is entitled to a deduction for charitable contributions. In a situation where the terms of the will or trust require a percentage of trust income to be distributed to charity and part of this distribution consists of long-term capital gain, the charitable deduction under 1954 Code Section 642(c) is determined with regard to the inclusion of 100 per cent of such gains in gross income. However, appropriate adjustment must be made for the Section 1202 deduction of 50 per cent of the excess of long-term gains over short-term losses. In other words, the Section 1202 deductions are first taken and the balance remaining is considered the amount available for distribution.[67]

Capital gains do not lose their character as such in the hands of the distributees. In a situation where a fiduciary distributes capital gain under circumstances entitling it to a deduction (i.e. where the distribution is a current one), the distribution is treated as capital gain by the beneficiary.[68] To the extent it is net long-term capital gain, he is entitled to the 50 per cent deduction provided by Section 1202.

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[66] 1954 IRC § 1202; 1939 IRC §§ 23(ee) and 117(b).

[67] Footnote 56, above.

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How to Buy and Sell Securities

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The provisions in the internal revenue law with respect to the purchase and sale of securities have become increasingly complex, and the line of demarcation between capital and ordinary income has, in many instances, become indistinguishable. Under these circumstances, it is incumbent upon every taxpayer to avail himself of the full measure of opportunity to minimize his tax burden by knowing how to buy and sell securities effectively.

1. Problems and Pitfalls Considered

In security transactions, it is not enough that the taxpayer has securities that he wishes to sell and has found a buyer willing to pay a mutually satisfactory price. He must solve a multitude of problems, the more formidable of which include:

	Section
Does he have a "capital asset"?	2
Will the sale of securities result in long-term or short-term gain or loss?	2
Will the alternative tax computation be of tax benefit to him?	3
How does he measure the holding period under various situations of acquisition?	4
How does he determine basis of the securities?	5
What effect do short sales and puts and calls have upon the holding period?	6, 7, 8
What will be the taxable effects of trading in "when-issued" securities and "when-issued" contracts?	9, 10
When are stock dividends and stock rights taxable and when nontaxable, and of what problems of basis must the taxpayer be cognizant upon a subsequent sale of such dividend stock and stock rights?	11, 12
When does he hold Section 306 stock and what are the tax consequences of redemption or other disposition?	13

Cautious investment planning calls for due consideration of whether particular amounts received for securities result in ordinary or capital income. This may depend upon whether the transaction in question is a

	Section
Conversion	14
Retirement or sale of bonds	15

A taxpayer must be wary of certain pitfalls in connection with security transactions. Has the taxpayer:

	Section
Sold stock in a wash sale?	16, 17
Failed to identify shares in common lots?	18
Sold stock to certain related persons?	19

For example, what may appear to be a deductible loss upon a sale of securities may be disallowed because of special rules incident to wash sales or sales to related persons. Questions with respect thereto have resulted in litigation before appellate tribunals, including the Supreme Court.

The foregoing are some of the elements requiring consideration in connection with the purchase and sale of securities.

2. Timing Security Transactions

The capital gain and loss provisions of the law place certain limitations on the application of the general rule that where property is sold or exchanged, the gain arising therefrom is taxable, and any loss sustained is deductible. In order for these limitations to operate, however, a dual condition must be met:

1. The property disposed of must be a "capital asset" as defined in the statute, and
2. The capital asset must be disposed of in a "sale or exchange." Once these requirements are met, the special taxing method provided by the statute comes into play.

Stock or securities are always capital assets unless—

They constitute the taxpayer's stock in trade or other property of a kind properly includible in inventory.

They are held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.[1]

The length of time the capital asset has been held determines whether it results in long-term or short-term gain or loss upon sale or exchange. There are only two holding periods: one for short-term gains and losses, which is six months or less; the other for long-term gains or losses, which is more than six months.[2] All short-term items are aggregated to produce a *net* short term capital gain or loss; likewise, all long-term items are aggregated to produce a *net* long-term capital gain or loss. The aggregate of these net results will produce net capital gain or net capital loss.

Since the Revenue Act of 1951, differing percentages are no longer applied to long-term and short-term transactions of individual taxpayers. Under current law, an individual taxpayer takes into account the entire amount of gain or loss, whether the transaction be long-term or short-term, but if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 per cent of the amount of such excess constitutes a deduction from gross income.[3] If there is an excess of such net capital loss over net capital gain, an individual taxpayer may still deduct $1,000 of such loss from his ordinary income, and if the amount of his taxable income (computed without regard to such capital gains or losses and without regard to the deductions relating to personal exemptions or any deduction in lieu thereof) is less than $1,000, he may deduct the loss to the extent of such taxable income. The balance of such loss, if any, may then be carried over as a short-term capital loss in each of the five succeeding taxable years, and applied successively in the same manner against capital gains and taxable income.[4]

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[1] 1954 IRC § 1221; 1939 IRC § 117(a).

[2] 1954 IRC § 1222; 1939 IRC § 117(a).

The Revenue Act of 1951 made no change in the computation of capital gains or losses of a corporation, the entire amount of which is still taken into account, and there is no deduction from gross income corresponding to that permitted an individual taxpayer. Furthermore, corporations do not have the privilege of applying net capital losses against $1,000 of their taxable income. Their capital losses are allowed only to the extent of their capital gains, but they do have a carry-over against capital gains for the same five-year period.[5]

In spite of the elimination of percentages, the distinction between long- and short-term capital transactions is still important because upon it depends the availability of the alternative tax computation.

3. Alternative Tax Computation

Where the net long-term capital gain (excess of long-term capital gains for the taxable year over long-term capital losses for such year) of a taxpayer exceeds the net short-term capital loss (excess of short-term capital losses for the taxable year over the short-term capital gains) for the taxable year, the alternative tax computation becomes important. It works like this:

1. An individual taxpayer should first compute his tax at the regular rate upon his taxable income, after including therein the entire amount of net capital gain less 50 per cent of the excess of net long-term capital gain over net short-term capital loss.

2. The alternative computation is made by computing, at the regular rate, the tax on taxable income, reduced by an amount equal to 50 per cent of the excess of the net long-term capital gain over the net short-term capital loss, to which a flat 25 per cent of such excess is then added. (Inasmuch as the deduction permitted under §1202 of the 1954 Code is not available to a corporate taxpayer, such a taxpayer reduces taxable income by the entire excess of net long-term gain over short-term capital loss, the tax on such taxable income is computed at regular rates, and to such tax is added 25 per cent of such excess, or, in the case of a taxable year beginning before April 1, 1954, an amount equal to 26 per cent of such excess.) The taxpayer then pays the smaller tax.[6]

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[3] 1954 IRC § 1202; 1939 IRC §§ 117(b), 23 (ee). Prior to the Revenue Act of 1951, § 117(b) of the 1939 Code set forth the percentages to be taken into account, to wit, 100 per cent of any gain or loss upon the sale or exchange of a capital asset held for six months or less, and 50 per cent of any gain or loss where the capital asset was held for more than six months. The effect of the amendment by the 1951 Act was to eliminate these percentages.

[4] 1954 IRC §§ 1211 and 1212; 1939 IRC §§ 117(d) and (e).

[5] 1954 IRC §§ 1211, 1212; 1939 IRC §§ 117(d) and (e).

[6] 1954 IRC § 1201; 1939 IRC § 117(c).

Except in the instance noted with respect to corporations, the effect of the alternative computation is to prevent a tax of more than 25 per cent on the actual amount of long-term gains. This has given rise to the commonly accepted but not entirely accurate notion that the tax upon long-term capital gain transactions is 25 per cent. Rather, the tax upon such transactions may not exceed 25 per cent, and in some instances may even be less. The alternative computation is confined to situations in which the taxpayer's net long-term capital gain exceeds his net short-term capital loss. If a taxpayer has only long-term capital gains for the taxable year, his short-term losses are zero, and the required excess is present.

The taxpayer should always bear in mind that proper and careful timing will produce long-term gains (taxable at a maximum effective 25 per cent rate) and short-term losses.

4. Measurement of Holding Period

All considerations pertaining to proper timing depend upon the holding period and the measurement of that period. The exact length of time the securities are held is of the utmost importance. An error of one day may convert a short-term transaction into a long-term transaction, or vice versa. The rules in computing the holding period are as follows. If the securities are acquired:

1. By purchase generally. The day on which they were acquired is excluded; the day on which they were disposed of is included.[7]
2. By purchase on the stock exchange. The date of purchase is the date when the purchase order is executed, not the date when the securities are received by the purchaser or his broker. Conversely, the date of their sale on the exchange is the date when the sell order is executed, not the date when the securities are delivered by the seller or his broker.[8]
3. In a tax-free exchange. The holding period of the property surrendered upon the exchange is added to the period during which the new property was held, and, in the case of such exchanges after March 1, 1954, if the property exchanged was a capital asset at the time of such exchange.[9]
4. In a taxable exchange. The day of receipt marks the beginning of the holding period.
5. By way of gift after December 31, 1920. The holding period begins with the date the securities were acquired by the donor, if they are being sold at a gain. If they are being sold at a loss, and the basis for determining such loss is their value at the date of the gift, the holding period dates back only to the date of the gift.[10]
6. By way of gift before January 1, 1921. The holding period begins with the date of the gift.
7. By inheritance. The holding period begins at the date of death.[11]
8. As a taxable stock dividend. The date basis of the new shares is the date received.

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[7] I.T. 3287, 1939-1 C.B. 138; *S. H. Fogel* v. *Commissioner* (5 Cir. 1953), 203 F. 2d 347.

[8] I.T. 3705, 1945 C.B. 174.

[9] 1954 IRC § 1223(1). 1939 IRC § 117(h)(1) contained no requirement that the assets exchanged and received be capital assets.

[10] 1954 IRC § 1223(2); 1939 IRC § 117(h)(2); I.T. 3453, 1941-1 C.B. 254.

[11] *McFeely* v. *Commissioner*, 296 U.S. 102(1935).

9. As a nontaxable stock dividend. The date basis of the new shares is the same as the date basis of the old shares, and the holding period runs from the earlier date.[12]

10. In a wash sale. The holding period begins with the date the original stock was acquired. The holding period of the disallowed sale is added to the holding period of securities sold in the wash sale.[13] Where several lots of stock are involved in wash sales, the holding periods of old lots are added to that of the new lot.[14]

11. By a partner as a distribution in kind. Such securities are deemed to have been held by such partner since their acquisition by the firm (or since their original acquisition by a partner if they were contributed in kind to the firm). Thus, even if a partner immediately sells securities received from his firm, the transaction may be long-term if the securities were held by the firm or by a partner who contributed them to the firm, for the required period.[15]

5. Basis of Securities

The prime factor in the computation of recognized gain or loss upon the disposition of securities is basis. Basis is the tax cost at which the taxpayer is deemed to have acquired the securities disposed of. Whether such basis is actual cost, fair market value as of a particular date, or a substituted basis depends upon the manner in which the taxpayer acquired the securities.

The rules outlined below relate to the unadjusted basis of the securities sold or exchanged. In actuality, such initial tax cost or unadjusted basis, whether it be actual cost, fair market value, or a substituted figure, should be adjusted to reflect certain additions to and reductions from capital. For example, proper additions to the unadjusted basis of securities may be purchase commissions and costs of defending title, whereas reductions in basis may consist of dividends on stock distributed out of capital when the corporation has no earnings available for payment.

The resultant figure is adjusted basis. It is this figure that is compared with the amount realized to ascertain the existence of gain or loss. The amount realized includes not only cash, but also the fair market value of any other property received.

The rules are as follows:[16]

1. If the securities are acquired by purchase generally the unadjusted basis is cash cost plus amount of any mortgage indebtedness.

2. If they are acquired in a taxable exchange, the unadjusted basis is fair market value of the property transferred in exchange therefor, valued at the time of exchange.

3. If they are acquired in a tax-free exchange, the unadjusted basis is a substituted basis—for example, the securities assume the basis of the property transferred (adjusted to the date of exchange).

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[12] 1954 IRC § 1223(5); 1939 IRC § 117(h)(5). The 1954 Code extends this rule to stock acquired in a spin-off. Sen. Fin. Rep. No. 1622, 83d Cong. 2d Sess., 432.

[13] 1954 IRC § 1223(4); 1939 IRC § 117(h)(4). See "Wash Sales," Section 16 of this Chapter.

[14] Letter Ruling, Bureau of Internal Revenue, 2/25/48; *Prentice-Hall* 1948 *Federal Tax Service*, para. 76, page 238.

[15] G.C.M. 11557, 1933-1 C.B. 128; G.C.M. 20251, 1938-2 C.B. 169. See *Allan S. Lehman*, 7 T.C. 1088(1946), affirmed (2 Cir. 1948) 165 F. 2d 383, 36 AFTR 545.

[16] 1954 IRC §§ 1012 *et seq.*; 358; 1939 IRC § 113.

4. If they were acquired by way of gift after December 31, 1920, the unadjusted basis is the donor's basis, where the sale or exchange of the securities results in gain. If such sale or exchange results in loss, the basis is the lesser of the donor's basis or the fair market value as of the date of gift. For example, in 1954, donor makes a gift of securities to taxpayer who sells in 1955. Cost to donor was $5,000. Thus:

Value of Gift	*Taxpayer's Selling Price*	*Gain*	*Loss*
$ 7,500	$10,000	$5,000	
10,000	3,500		$1,500
7,500	6,500	1,500	
3,500	4,500	None	None

In the last instance, there is no gain or loss. To compute gain, cost is used ($5,000). Thus, there is no gain. To compute loss, the lesser of cost or fair market value is used ($3,500). Thus, there is no loss either.

5. If the securities were acquired by way of gift before January 1, 1921, for all purposes, the unadjusted basis is fair market value as of date of gift.

6. If they are acquired by inheritance, for all purposes, the unadjusted basis is fair market value as of date of death, unless executor elects to value estate as of one year after date of death, when basis may be fair market value as of later date.

7. If they were acquired by any method prior to March 1, 1913, the unadjusted basis is the greater of cost or fair market value as of March 1, 1913, where the sale or exchange of the securities results in gain. Where such sale or exchange results in loss, basis is cost. For example, in 1910, taxpayer purchased securities for $5,000. He wishes to sell them in 1955. Thus:

March 1, 1913 Value	*Taxpayer's Selling Price*	*Gain*	*Loss*
$7,500	$10,000	$2,500	
7,500	3,000		$2,000
3,500	6,500	1,500	
7,500	6,500	None	None

8. If they are acquired as a taxable stock dividend, the unadjusted basis is fair market value upon date of receipt. The basis of the original shares remains unchanged.

9. If they are acquired as a nontaxable stock dividend, the unadjusted basis is the basis of original shares spread over the aggregate number of original shares plus those issued as a stock dividend. See Section 12, "Basis of Stock and Stock Rights Acquired in Distribution," on page 1157.

10. If they are acquired as nontaxable or taxable stock rights, see Section 12, "Basis of Stock and Stock Rights Acquired in Distribution," on page 1157.

11. If they are acquired in a wash sale, the unadjusted basis is cost of the new stock plus the loss not allowed. See Section 16, "Wash Sales," and Section 17, "Basis of Wash Sale Stock," on pages 1163 and 1165.

6. Effect of Short Sales, and Puts and Calls, Upon the Holding Period

Where securities increase in value within six months after acquisition, the taxpayer's dilemma is that disposition of such securities will result in short-term gain, whereas their retention may result in a decline in value by the time the long-term period arrives. Prior to the Revenue Act of 1950, a wide area of flexibility existed, particularly with respect to short selling, wherein the taxpayer could "stretch" the holding period from short-term to long-term by delivering stock which he had owned for more than six months to cover the short sale. Section 211 of the 1950 Act, which added Section 117(l) to the Internal Revenue Code of 1939, and Section 1233 of the Internal Revenue Code of 1954 have introduced specific rules concerning short sales which limit the freedom of maneuverability that taxpayers previously enjoyed. In this connection puts and calls, and certain options to buy or sell should likewise be considered.

7. Short Selling

A short sale is an investment technique. The investor, anticipating a decline in the price of certain stock, sells stock that he does not own in the hope that subsequently he will be able to "cover," or to make delivery of the stock sold by purchasing it at the later and lower price. Delivery of the stock at the time of sale is accomplished by the borrowing of the stock by the investor's broker. Under Section 1233(a), gains and losses from such short sales of property are considered as gains or losses from the sale or exchange of capital assets, to the extent that the property used to close the short sale constitutes a capital asset in the hands of the taxpayer. Thus, the nature of gain or loss from the short sale will be determined by the character of the property used to close the sale.

The regulations promulgated under the 1939 Code provide that a short sale is not deemed to be consummated until delivery of property to cover the short sale, and whether the recognized gain or loss from a short sale is long-term or short-term capital gain or loss is to be determined according to the period for which the property so delivered was held.[17] Thus, if a taxpayer made a short sale of shares of stock and covered the short sale by purchasing and delivering shares which he held for not more than six months, the recognized gain or loss would be considered short-term capital gain or loss, even though he had on hand other shares of the same stock which he held for more than six months. If the short sale is made through a broker and the broker borrows property to make delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker. Usually a covering purchase is made immediately prior to closing the short position and results in short-term gain or loss, inasmuch as the holding period is only one day. Under current law, the entire amount of the gain or loss from a short sale is to be taken into account irrespective of whether such gain or loss is deemed short or long.[18]

Specific rules as to the tax consequences of certain short sales of stock and other securities are set forth in the statute.[19] These rules apply only where the dealings are in securities that are capital assets in the hands of the taxpayer.

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[17] Reg. 118, Sec. 39.117(g)-1; *Betty Klinger* (1949), par. 49,132 *Prentice-Hall Memorandum T.C.*; see also Proposed Regs. § 1.1233-1.

[18] See footnote 3, above.

[19] 1954 IRC § 1233; 1939 IRC § 117(l); Reg. 118, Sec. 39.117(l)-1; see also Proposed Regs. § 1.1233-1. As to property that is "substantially identical," see "Wash Sales," Section 16, and footnotes 61-65, incl.

The first two rules apply if gain or loss on the short sale would be considered capital gain or loss and if property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than six months or is acquired by him after the short sale and on or before the date of the closing thereof. In such case:

Rule 1: Any gain upon the closing of the short sale is considered as a short term capital gain. This rule applies without regard to when the property actually used to close the short sale was acquired.

Example (1): On January 1, 1955, X instructs his broker to sell short 100 shares of Z corporation at 50. per share. X owned no stock in Z. On February 1, 1955, X orders a covering purchase made at 40. per share. X has a short-term capital gain of $1,000. (5000-4000).

Example (2): Assume same facts as in Example (1) except that X was a stockholder in Z, having acquired 100 shares on December 1, 1954 at 40. per share. On February 1, 1955, X closes the short sale by delivering his own shares. Since X had held his stock for less than six months, the gain is short-term capital gain.

Rule 2: The holding period of such substantially identical property is considered to begin on the date of the closing of the short sale, or on the date of a sale, gift, or other disposition of such property, whichever date occurs first. If several quantities of property substantially identical to that sold short were acquired at different times, not more than six months prior to the short sale and prior to the closing thereof, this rule applies to such property in the order of the dates of its acquisition.

Example: On July 1, 1954, X buys 100 shares of Z stock at 40. per share. On January 1, 1955, he sells short 100 shares at 50. per share. On February 1, 1955 he buys 100 shares at 55. per share to close the short sale. On February 2, 1955 he sells the 100 shares bought on July 1, 1954 at 55. per share.

The $500.00 loss on the closing of the short sale (5500-5000) is a short term capital loss to which Rule (2) has no application. However, by application of such rule, the holding period of the 100 shares bought on July 1, 1954 and sold on February 2, 1955 is considered to begin on February 1, 1955, the date of closing of the short sale. The $1500 gain (5500-4000) is a short-term capital gain.

The third rule is applicable wherever property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for more than six months. In such case:

Rule 3: Any loss upon the closing of the short sale is considered as a long-term capital loss. This rule, like rule (1), applies without regard to when the property actually used to close the short sale was acquired.

8. Puts and Calls; Options to Buy or Sell

Put and call transactions come within the provisions of the revenue law which relate to options to buy or sell property.[20]

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[20] 1954 IRC §§ 1233(e), 1234; 1939 IRC § 117(g)(2); I.T. 2858, 1935-1 C.B. 147; *Batter,* 37 B.T.A. 667 (1938), dismissed CA of DC (1938). See also Crane, Burton, "Put Tax Change Poses a Paradox" and "Put, Call Writers Can Get Big Yields," *New York Times,* Sec. 3, Nov. 14 and 21, 1954, respectively.

The purchase of a put gives the purchaser the right to put or sell to the vendor certain stock at a certain price within a designated period. The purchase price of a put is generally fixed at a few points below the current market for the stock. The purchase of a call gives the holder the right to call or buy from the vendor certain stock at a certain price within a designated period. The purchase price of a call generally is fixed at a few points above the current market for the stock.

Example. Suppose that stock X is selling at 80. For $200 an investor may be able to buy a put for 100 shares at 77, good for 30 days, or for $100, he may be able to buy a call at 83, good for 30 days. If the stock declines in value below 77, the holder of the put will exercise it. If it rises above 83, the holder of the call will exercise it.

Generally, the acquisition of an option to sell property at a fixed price (put) will be considered a short sale, and the exercise or failure to exercise such option will be considered as a closing of such short sale, subject to the specific rules set forth in Section 1233(b) with respect to short sales.[21] However, Section 1233(c) of the 1954 Code sets forth an exception to the general rule. It provides that a "put" acquired after August 16, 1954 will not be presumed a short sale if it is bought on the same day as the stock that is to be used to fulfill the contract. This exception makes it possible for a taxpayer to get long term capital gains treatment when he buys a "put" with the stock that is to be used to exercise the "put," in order to hedge against a decline in its value. Thus, a person who purchases stock on February 1, 1955, with a 3-month "put" and who fails to exercise his "put," will have a long term gain or loss if he sells the stock on September 1. If such an option to sell property at a fixed price is not exercised, the cost of the option is to be added to the basis of the property with which the option is identified. The method of identification is to be prescribed by regulations.

If the option is exercised by the sale of property not purchased on the same day as the option, the general rule in Section 1233(b) will apply. If such an option is not purchased on the same day as property which could be used in the exercise of the option, the general rules applicable to options in Section 1234 will apply.

Section 1234 is partially derived from Section 117(g)(2) of the 1939 Code, insofar as it relates to the tax treatment of loss on failure to exercise an option. Insofar as it relates to gains or losses arising from the sale or exchange of options, it is new.

It has been ruled under pre-existing law that an option, like any other property right, was subject to general capital gain provisions and, hence, its sale would give rise to a capital gain or loss where the holder was not in the business of dealing in such options.[22] Section 1234 changes the law to the extent that options are regarded as capital assets only where the underlying property constitutes, or if acquired would constitute, a capital asset in the hands of the holder. Thus, options relating to noncapital assets will, if sold, give rise to ordinary gain or loss.

If the taxpayer never acquires the property subject to the option, the nature of his gain or loss is determined by whether the property would have been a capital asset if he had acquired it. For example, if a dealer in securities acquires an option to buy certain securities and fails to exercise the option, the loss would be an ordinary loss since he normally holds such property for sale to customers in the course of his trade or business. However, if an investor acquires an option to buy securities and sells the option at a gain, he would have a capital gain since the property, if acquired, would have been a capital asset in his hands.

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[21] Section 1233(b); see "Short Selling," Section 7 of this Chapter.
[22] G.C.M. 23677, 1943, 1943 C.B. 370.

Section 117(g)(2) of the 1939 Code provides that loss to the holder and gain to the grantor on failure to exercise any option is considered a short-term capital gain or loss. Section 1234 provides that such loss to the holder will be a capital loss only where the option relates to a capital asset. Accordingly, unexercised options entered into for hedging purposes with regard to stock in trade or inventory-type assets, will be deductible as ordinary losses rather than, as heretofore, capital losses. The gain to the grantor in all cases will be ordinary income rather than a short-term capital gain.[23]

In order fully to equate the tax treatment of loss on failure to exercise an option to loss on the sale of such an option, such a loss, if capital in nature, is treated as a long-term loss where the option is held for 6 months. Therefore, where such an option is held for 6 months, it will make no tax difference whether the holder sells it at a loss or fails to exercise it.[24]

9. "When-Issued" Trading

Trading in "when-issued" securities is carried on by the execution of contracts for the purchase and sale of new securities not yet in existence, at specified prices, "when, as, and if issued." Trading in securities on a "when-issued" basis is usually incident to a plan of reorganization of a corporation, providing for the issuance of new securities in exchange for outstanding securities, and relates to the nonexistent new securities.

However, dealings in "when-issued" securities are not sales of stock, but merely sales of contracts to buy and sell stock. No actual sale of the securities can take place until the new stock is issued.[25] If the plan of reorganization is not consummated, the contracts are voided. If it is consummated, the holders of "buy" contracts must purchase the securities pursuant to the terms of such contracts, and the holders of "sell" contracts must deliver in accordance with the terms of the contracts.

A contract to sell stock or other securities on a "when issued" basis is considered a short sale, and the performance or assignment for value of the contract is considered as a closing of such short sale.[26]

10. "When-Issued" Contracts

Other transactions involve the purchase and sale of "when-issued" contracts. A contract to buy or sell "when-issued" stock is a capital asset (except in the hands of a dealer), distinct and apart from the security itself, and upon the sale of the contract the capital gain and loss provisions apply. The holding period starts when the contract is executed and terminates upon its sale or other disposition. If a buy contract is performed, so that the securities contracted for are purchased when actually issued, the holding period of the contract is not added to the holding period of the securities.[27]

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[23] It is to be noted that losses on failure to exercise options described in Section 1233(c), i.e. puts, are specifically excepted from Section 1234.

[24] Sen. Fin. Rep., footnote 12 above, 437-38.

[25] I.T. 3721, 1945 C.B. 164; see *Lewis K. Walker*, 35 B.T.A. 640 (1938).

[26] 1954 IRC § 1233(e)(2)(A); 1939 IRC § 117(l)(3)(B).

Where there is a combination of buy and sell contracts, no gain or loss is realized when an individual, after buying or selling securities on a "when-issued" basis, sells or buys the same securities on a "when-issued" basis, unless and until the reorganization is consummated. Under these circumstances, there is no closed transaction.

Upon consummation of the reorganization and the acquisition of the new stock by the individual pursuant to his buy contract and the sale pursuant to his sell contract, gain or loss is realized. Where an individual has both a "when-issued" buy and a "when-issued" sell contract entered into at different prices, each contract is to be treated as a separate capital asset upon the sale of both contracts to another individual. Gain or loss would be the difference between the consideration received for each transfer and the consideration paid.

In some cases, payment is made for the assumption of a liability under a contract. Where an individual pays another to assume the former's obligations under a "when-issued" buy or sell contract, the loss to the former is a capital loss. The holding period is measured by the length of time the contract was held. Where an individual receives money from another to assume the latter's obligation under a "when-issued" sell contract, such amount does not constitute ordinary income at the time of receipt, but it is a factor to be considered in determining ultimate gain or loss derived when the contract is carried out or voided, depending on the consummation of the reorganization.

If the contract is carried out, the taxpayer has capital gain or loss, and the holding period is measured by the length of time he held the stock before delivery under the contract to sell. If the reorganization is not consummated and the contract is voided, he has ordinary income as of the time it is established that the reorganization will not be consummated.[28]

The "first in, first out" [29] rule is not applicable to stock purchased on a "when issued" basis because the buy contracts are all settled on the settlement date, and the shares received pursuant to such contracts are received simultaneously. However, if the stock received on the settlement date pursuant to the buy contracts is not properly marked for identification purposes, then a rule similar to the "first in, first out" rule should be applied and the shares of stock used to settle the sell contract should be charged against the shares of stock acquired pursuant to the earliest buy contracts.[30]

11. Distribution of Stock and Stock Rights

A stock dividend is a distribution made by a corporation to its stockholders in its *own* stock. Stock rights are issued by a corporation to its stockholders to give them the opportunity to subscribe to a new issue of stock. Such rights generally have a market value, inasmuch as they give the shareholder the privilege of purchasing the new stock at less than the quoted price.

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[27] See *Fleda F. Iverson* (1943), par. 43,124 *Prentice-Hall Memorandum* T.C.

[28] See above, footnote 25, I.T. 3721.

[29] See "First-in, First-out" Rule, Section 18 of this Chapter.

[30] I.T. 3858, 1947-2 C.B. 71. Under 1954 IRC § 1233 and 1939 IRC § 117(l), certain transactions on a "when issued" basis may be treated as a short sale.

The current law provides that except where the distribution is "in lieu of money," no amount shall be includible in income upon the receipt by a shareholder from a corporation, of shares of its stock, or its stock rights, which are issued with respect to the stock held by such shareholder.[31] A distribution of stock or rights to acquire stock is treated as a distribution of property to which Section 301 applies if the distribution is made in discharge of preference dividends on stock of the corporation for the taxable year of the distribution or for the preceding taxable year.[32] If any shareholder has the right to an election or option with respect to whether a distribution shall be made either in money or any other property or in stock or rights to acquire stock, then the entire distribution will be treated as a distribution of property to which Section 301 applies regardless of (a) whether the distribution is actually made in whole or in part in stock or in stock rights; (b) whether the election is exercised or exercisable before or after the declaration of the distribution; or (c) whether the declaration of the dividend provides that payment will be made in one medium unless the shareholder specifically requests payment in the other, or whether all or part of the shareholders have the election.[33]

12. Basis of Stock and Stock Rights Acquired in Distribution

a. General rule. If a shareholder receives stock or stock rights as a distribution on stock previously held and such distribution is not includible in gross income then the general rule is that the basis of the stock with respect to which the distribution was made shall be allocated between the old and new stocks or rights in proportion to the fair market values of each on the date of distribution. If a shareholder receives stock or stock rights as a distribution on stock previously held and part of the distribution is not includible in gross income the basis of the stock with respect to which the distribution is made shall be allocated between the old and new stocks or rights in proportion to the fair market value of each on the date of distribution without regard to the fair market value of any part of such distribution which is includible in gross income. The date of distribution in each case shall be the date the stock or the rights are actually distributed to the stockholder and not the record date. The general rule will apply with respect to stock rights only if such rights are exercised or sold.[34]

Example: A taxpayer in 1947 purchased 100 shares of common stock at $100 per share and in 1954 by reason of the ownership of such stock acquired 100 rights entitling him to subscribe to 100 additional shares of such stock at $90 a share. Immediately after the issuance of the rights, each of the shares of stock in respect of which the rights were acquired had a fair market value, ex-rights, of $110 and the rights had a fair market value of $19 each. The basis of the rights and the common stock for the purpose of determining the basis for gain or loss on a subsequent sale or exercise of the rights or a sale of the old stock is computed as follows:

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[31] 1954 IRC § 305(a), applicable to distributions on and after June 22, 1954. In this respect, the 1954 Code eliminates the intricate and confused problems stemming from *Eisner* v. *Macomber*, 252 U.S. 189, 3 AFTR 3020 (1920), and reflected in cases such as *Koshland* v. *Helvering*, 298 U.S. 441, 17 AFTR 1213 (1936); *Helvering* v. *Griffiths*, 318 U.S. 371, 30 AFTR 403 (1943); *Helvering* v. *Sprouse*, 318 U.S. 604, 30 AFTR 1087 (1943); *Strassburger* v. *Commissioner*, 318 U.S. 604, 30 AFTR 1087 (1943); *Tourtelot* v. *Commissioner* (7 Cir. 1951), 189 F. 2d 167, 40 AFTR 668; *Wiegand* v. *Commissioner* (3 Cir. 1952), 194 F. 2d 479, 41 AFTR 721; *C. P. Chamberlin*, 18 T.C. 164 (1952), rev'd (6 Cir. 1953) 207 F. 2d 462, cert. den. March 8, 1954; *Joseph P. Schmitt, et al.*, 20 T.C. 352 (1953), rev'd (3 Cir. 1954) 208 F. 2d 819, wherein the taxability of a stock dividend or stock right distribution depended upon whether the proportionate interest of the stockholder in the corporation was altered.

[32] 1954 IRC § 305(b)(1).

[33] Final Regs. § 1.305-2.

[34] 1954 IRC § 307(a); Final Regs. § 1.307-1.

100 (shares) × $100 = $10,000, cost of old stock (stock in respect of which the rights were acquired).
100 (shares) × $110 = $11,000, market value of old stock.
100 (rights) × $19 = $1,900, market value of rights.

$\frac{11,000}{12,900}$ of $10,000 = $8,527.13, cost of old stock apportioned to such stock.

$\frac{1,900}{12,900}$ of $10,000 = $1,472.87, cost of old stock apportioned to rights.

If the rights are sold, the basis for determining gain or loss will be $14.7287 per right. If the rights are exercised, the basis of the new stock acquired will be the subscription price paid therefor ($90) plus the basis of the rights exercised ($14.7287 each) or $104.7287 per share. The remaining basis of the old stock for the purpose of determining gain or loss on a subsequent sale will be $85.2713 per share.[35]

b. Exception for certain stock rights. The basis of rights to buy stock which are excluded from gross income will be zero if the fair market value of such rights on the date of distribution is less than 15 percent of the fair market value of the old stock on that date, unless the shareholder elects to allocate part of the basis of the old stock to the rights as provided under the general rule in subparagraph (a) above.[36] The election shall be made by a shareholder with respect to all the rights received by him in a particular distribution in respect of all the stock of the same class owned by him in the issuing corporation at the time of such distribution. Such election to allocate basis to rights shall be in the form of a statement attached to the shareholder's return for the year in which the rights are received. This election, once made, shall be irrevocable with respect to the rights for which the election was made. Any shareholder making such an election shall retain a copy of the election and of the tax return with which it was filed, in order to substantiate the use of an allocated basis upon a subsequent disposition of the stock acquired by exercise.[37]

13. Dispositions of Certain Stock—Section 306 Stock

a. Purpose. Section 306 of the 1954 Code (which has no counterpart in the 1939 Code) was enacted into law to close the loophole known as the "preferred stock bail-out." This was a device whereby the stockholders of a corporation caused a dividend in preferred stock to be declared on their common stock.

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[35] Final Regs. § 1.307-1.
[36] 1954 IRC § 307(b).
[37] Final Regs. § 1.307-2.

Thereafter, the stockholders sold such preferred stock. The corporation would then utilize its earnings and profits to redeem the stock from the purchaser. Such a transaction was held to subject the stockholders to capital gains tax at the time of their disposition of stock,[38] even though the overall effect of what was accomplished was equivalent to the distribution of an ordinary dividend.[39] Section 306 is designed to tax as ordinary income the proceeds of a sale, redemption, or other disposition (such as a pledge) of such a nontaxable stock dividend. If stock does not qualify as Section 306 stock, its sale, redemption or other disposition will be governed by the applicable provisions of the Code in the determination of whether the distributee has ordinary income or capital gain.

b. Definition of Section 306 stock. In general, Section 306 stock may be stock falling within any one of these categories: (1) stock dividend stock (other than common on common) which was nontaxable when received; or (2) stock (other than common) received in corporate reorganizations, split-offs, split-ups, or spin-offs, to the extent that the effect was substantially the same as the receipt of a stock dividend, or if it was received in exchange for Section 306 stock; or (3) stock other than that covered in (2), which has a transferred or substituted basis, determined by reference to the basis of Section 306 stock in the hands of any person.

Common stock under (1) received as a stock dividend will be considered Section 306 stock even though it is nontaxable if it is distributed with respect to stock which is not common stock, such as in payment of arrearages on preferred stock dividends. On the other hand, common stock received in exchange for Section 306 stock in a recapitalization will not be considered Section 306 stock.[40]

If the corporation does not have any earnings and profits available for distribution at the time the stock is distributed, then the stock will in no event be Section 306 stock.[41] Stock rights are treated the same as stock for purposes of this Section and stock acquired through the exercise of the rights is treated as stock distributed at the time of the distribution of the rights, to the extent of the fair market value of the rights at the time of the distribution.[42]

c. Redemption and dispositions other than redemptions. Section 306 draws a distinction between a disposition of Section 306 stock by redemption or by means other than a redemption.

If a shareholder sells or otherwise disposes of stock (other than by redemption or within the exceptions listed in Section 306(b) and hereinbelow noted), the entire proceeds received from such disposition is to be treated as gain from the sale of property not a capital asset, to the extent that the fair market value of the stock sold, on the date distributed to the shareholder, would have been a dividend to such shareholder had the distributing corporation distributed cash in lieu of stock. Any excess of the amount received over the sum of the amount treated as ordinary income plus the adjusted basis of the stock disposed of, is to be treated as gain from the sale of a capital asset or noncapital asset as the case may be. No loss is recognized. While the amount of earnings and profits at the time of distribution is one of the measures of the amount to be treated as ordinary income, no reduction of earnings and profits results from any disposition of stock other than a redemption.[43]

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[38] *Chamberlin* v. *Commissioner*, footnote 31 above.
[39] Sen. Fin. Rep., footnote 12, above, 46.
[40] Final Regs. § 1.306-3(c), (d).
[41] 1954 IRC § 306(c).
[42] 1954 IRC § 306(d).

Section 306(a)(1) may be illustrated by the following examples:[44]

Example (1). On December 15, 1954, A and B owned equally all of the stock of Corporation X which files its income tax return on a calendar year basis. On that date Corporation X distributed pro rata 100 shares of preferred stock as a dividend on its outstanding common stock. On December 15, 1954, the preferred stock had a fair market value of $10,000. On December 31, 1954, the earnings and profits of Corporation X were $20,000. The 50 shares of preferred stock so distributed to A had an allocated basis to him of $10 per share or a total of $500 for the 50 shares. Such shares had a fair market value of $5,000 when issued. A sold the 50 shares of preferred stock on July 1, 1955, for $6,000. Of this amount $5,000 will be treated as gain from the sale of property which is not a capital asset; $500 ($6,000 minus $5,500) will be treated as gain from the sale of a capital or noncapital asset as the case may be.

Example (2). The facts are the same as in Example 1 except that A sold his 50 shares of preferred stock for $5,100. Of this amount $5,000 will be treated as gain from the sale of property which is not a capital asset. No loss will be allowed. There will be added back to the basis of the common stock of Corporation X with respect to which the preferred stock was distributed, $400, the allocated basis of $500 reduced by the $100 received.

If Section 306 stock is redeemed, the entire amount received by the shareholder is to be treated as a distribution of property under Section 301 subject to the general rules as to whether the amount is a dividend, a capital gain or return of capital. In the case of a redemption, the amount of the earnings and profits of the distributing corporation at the time the Section 306 stock was distributed is immaterial. The amount of earnings and profits at the time of redemption controls.

d. Exceptions. Specific instances in which the general rules as to the disposition of Section 306 stock do not apply are set forth.[45] Such rules do not apply to any disposition:

1. if it is not a redemption, is not, directly or indirectly, to a related person under the constructive ownership rules, and terminates the entire stock interest of the shareholder in the corporation (including stock constructively owned);
2. if it is a complete redemption of all the stock held in the corporation by the shareholder;
3. if it is redeemed in a distribution in partial or complete liquidation to which Part II applies;
4. to the extent that gain or loss would not be recognized to the shareholder on disposition of the Section 306 stock;
5. or if it is established to the satisfaction of the Secretary or his delegate that the distribution, and the disposition or redemption, were not in pursuance of a plan having as one of its principal purposes the avoidance of income tax.

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[43] Final Regs. § 1.306-1(a).

[44] Final Regs. § 1.306-1(b)(2).

[45] 1954 IRC § 306(b).

e. Miscellaneous provisions.[46] *1. Convertible stock.* If Section 306 stock which was distributed with respect to common stock, is exchanged for common stock in the same corporation (whether or not such exchange is pursuant to a conversion privilege contained in Section 306 stock), such common stock will not be Section 306 stock. This provision applies to exchanges not coming within the purview of Section 306(c)(1)(B) relating to stock which is not common stock and which is received in a corporate reorganization. Common stock which is convertible into stock other than common stock or into property, shall not be considered common stock. It is immaterial whether the conversion privilege is contained in the stock or in some type of collateral agreement.[47]

2. *Change in terms and conditions.* If there is a substantial change in the terms and conditions of any stock, then,

(A) the fair market value of such stock shall be the fair market value at the time of distribution or the fair market value at the time of such change, whichever is higher;

(B) the earnings and profits to be used as the measure of the amount to be treated as gain from the sale of property which is not a capital asset upon a disposition of such stock, shall be the earnings and profits at the date the stock was distributed or the earnings and profits on the date of such change, whichever amount is greater; and

(C) Section 306(c)(2) relating to the exception where there are no earnings and profits, shall be inapplicable if the distributing corporation had earnings and profits either at the time the stock was distributed or at the time the change in terms or conditions was made.[48]

3. *Applicability of section 306.* This section is inapplicable to stock received before June 22, 1954, and to stock received after June 22, 1954, in transactions subject to the provisions of the 1939 Code.[49]

14. Conversions

Under certain circumstances, bonds may be converted into stock, or one class of stock may be converted into another, without the recognition of gain or loss as a result. Where the owner of a bond exercises the right, provided for in the bond, to convert the bond into stock in the obligor corporation, the transaction does not result in a realization of profit or loss. The transaction is not closed for income tax purposes until the stock is sold.[50] Similarly, the exercise of a privilege, provided for in the preferred stock certificate, to convert into common stock of the same corporation results in no taxable income or deductible loss to the shareholder.[51] However, the conversion of bonds of one corporation into stock of another corporation is a transaction in which gain or loss may be recognized.[52]

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[46] Final Regs. § 1.306-3(f), (g) and (i).

[47] 1954 IRC § 306(e).

[48] 1954 IRC § 306(g).

[49] 1954 IRC § 306(h).

[50] I.T. 3056, 1937-1 C.B. 101.

[51] See Special Ruling, signed by Norman D. Cann, Deputy Commissioner, dated February 23, 1945, *Prentice-Hall Federal Tax Service* 1945, par. 76,130.

[52] I.T. 3056, above, note 50; *Estate of H. H. Timken*, 47 B.T.A. 494 (1942), affirmed (6 Cir. 1944) 141 F. 2d 625, 32 AFTR 445.

Another type of conversion is known as "arbitrage." As used generally on stock exchanges, the term means the purchase of one security and the short sale of another into which the first is convertible. The purchase and short sale are generally made contemporaneously.

For example, suppose that the Z Corporation has outstanding an issue of preferred stock, each share of which is convertible into two shares of common stock. X may purchase ten shares of the preferred stock and make a short sale of 20 shares of the common stock. This constitutes an arbitrage. If, in the foregoing example, the purchase of preferred stock is made at $10 per share and the short sale is at $5.50 per share, the profit is the "arbitrage spread." The holder need merely convert his preferred stock to close out the short sale. The holder has, under some circumstances, controlled the holding period and taken long-term gains and short-term losses by judicious conversion and covering of the short sales.[53]

15. Retirement and Sale or Exchange of Bonds

The 1954 Code sets forth new principles with respect to the retirement and sale or exchange of bonds, debentures, notes, or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof.[54]

1. *Retirement:* Amounts received by the holder on retirement of such bonds or other evidences of indebtedness are to be considered as amounts received in exchange therefor and subject to capital gains treatment.[55] In the case of bonds or other evidences of indebtedness issued before January 1, 1955, this rule will apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954.[56]

2. *Sale or exchange:* Upon the sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, issued at a price less than the redemption price, and held by the taxpayer more than six months, any gain realized as a result of the full or partial recovery of the original issue discount is to be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than six months. This discount rule does not apply to obligations the interest on which is fully exempt from taxation, or to any holder who has purchased the bond or other evidence of indebtedness at a premium.

If a bond or other evidence of indebtedness issued at any time with interest coupons is purchased after the date of enactment of the 1954 Code and the purchaser does not receive all the coupons which first became payable more than twelve months after the date of purchase, an artificial discount is deemed to have ensued from the detachment of an excess number of coupons and any gain on the later sale or exchange of such bond will be treated as ordinary income to the extent of the artificial discount so created.[57]

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[53] As to "arbitrage" in commodity transactions, see Sen. Rep. No. 2375, 81st Cong., 2d Sess., Revenue Act of 1950, page 45.

[54] 1954 IRC § 1232.

[55] 1939 IRC § 117(f) required all such bonds to be issued with interest coupons or in registered form to qualify for capital gains treatment.

[56] Under *Lurie* v. *Commissioner* (9 Cir. 1946), 156 F. 2d 436, securities of this type could be put in registered form at any time prior to retirement, and they would be treated as having been in registered form from the date of acquisition by the holder at retirement. This decision is thus overruled, prospectively, by providing that nonregistered, noncoupon bonds issued prior to March 1, 1954, must be in registered form on March 1, 1954, in order for their retirement to be treated as a sale or exchange. Sen. Fin. Rep., footnote 12, above, 433-434.

Example: Assume that a bond is selling at a price of 90 and carries a coupon rate of 3½ percent. If the bond is sold with three years' coupons detached, it might sell at a price of 80. At any time the purchaser sells this bond he will report the first ten points of his gain as ordinary income. If he resells it at a price of 92 after three years, ten points of his gain will be deemed ordinary income, and the remainder of the gain will be deemed either ordinary income or long-term capital gain, depending upon the application of the rule relating to original issue discount.[58]

16. Wash Sales

Where substantially identical stock or securities are acquired by purchase or taxable exchange within 30 days before or after their sale or other disposition, any loss upon the sale is not deductible for income tax purposes.[59] This rule covers a contract entered into for the acquisition of, or an option to acquire, substantially identical stock or securities. The rule does not apply, however, to individual traders, or to dealers, whether corporate or individual.[60]

Generally, the stock or securities must be the same in all important respects. For example, common stock and voting trust certificates representing common stock have been held to be substantially identical,[61] as were Series A and Series B debentures, where the only differences between the two issues were the dates of issue and the amounts to be redeemed annually.[62] On the other hand, common stock with voting power and Class A stock without voting power were found not to be substantially identical,[63] as were bonds of the same corporation differing with respect to interest rates, interest payment dates and dates of issuance and maturity.[64] Although, for the most part, the usual acceptations of the words "stock or securities" prevail, the word "securities" has been expanded to include commodity futures contracts and consequently contracts for "when-issued" securities.[65]

"Acquired by purchase or taxable exchange" implies that any acquisition by gift or inheritance, or any exchange upon which the amount of gain or loss is not recognized, would fall outside the operation of the section. "Within 30 days before or after" is referred to as the "61-day period" during which any of the contemplated transactions will be within the rule.[66] The necessity for a "sale or other disposition thereof" is clear from the statute.

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[57] 1954 IRC § 1232(c).

[58] Sen. Fin. Rep., footnote 12, above, 436.

[59] 1954 IRC § 1091; Proposed Regs. § 1.1091-1; 1939 IRC § 118; Reg. 118, Sec. 39.118-1.

[60] As to who are traders, see *Sol H. Morris*, 38 B.T.A. 265 (1938); as to dealers, see *Donander Company*, 29 B.T.A. 312 (1933).

[61] *Margaret E. Kidder*, 30 B.T.A. 59 (1934).

[62] I.T. 2778, XIII-I C.B. 79.

[63] I.T. 2585, X-2 C.B. 182.

[64] G.C.M. 21496, 1939-2 C.B. 169.

[65] *Trenton Cotton Oil Company* v. *Commissioner* (6 Cir. 1945), 147 F. 2d 33, 33 AFTR 610, rehearing den. (6 Cir. 1945) 148 F. 2d 208, 33 AFTR 910.

Does the wash sale rule apply to the purchase and sale of stock or securities by different but related taxpayers? In the case of a husband and wife filing separate returns, it has been held that the wash sale provisions do not operate to disallow the loss incident to the purchase and sale of the identical security.[67] Of course, the spouse must use his or her own funds and may not purchase the security from the other.[68] Where the spouses file a joint return and the wife makes a repurchase with her own funds, there is authority for permitting the deduction of the loss.[69]

Since these cases were decided, however, the Supreme Court has held that for certain purposes a joint return must be treated as a return of a single taxpayer,[70] and the soundness of the earlier authority may well be questioned in the light of the later decisions. The rule has been applied to a sale by an individual when the repurchase was made by his wholly owned corporation.[71] In the same vein, the Commissioner has determined that the wash sale provisions apply to losses sustained by a partner where one partner purchases substantially identical stock or

EXAMPLES OF "WASH SALES"
(Based on the Purchase and Sale of 100 Shares of the Same Stock)

Nondeductible Losses from "Wash Sales"	If you purchase the stock		And sell same		Then reacquire the stock		
	On	*For*	*On*	*For*	*On*	*How*	*For*
Repurchase of identical securities within 30 days after the sale at a loss	1/1/54	$5,000	12/15/54	$3,000	1/2/55	By Repurchase	$4,000*
Repurchase of identical securities within 30 days before the sale at a loss	1/1/54	5,000	1/2/55	3,000	12/15/54	By Prior Purchase	2,000*
Acquisition of the same securities by taxable exchange within 30 days before or after a sale	1/1/48	5,000	12/15/54	3,000	1/2/55	By Taxable Exchange	4,000*
Acquisition of the same securities by an exercise of rights within 30 days before or after a sale	1/1/54	5,000	1/2/55	3,000	12/15/54	By Exercise of Subscription Rights	4,000*

* Basis for the new securities would in each instance be the cost thereof plus the amount of the disallowed loss. See Section 17, "Basis of Wash Sale Stock."

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[66] Reg. 118, Sec. 39.118-1; Proposed Regs. § 1.1091-1.

[67] *Frank B. Gummey*, 26 B.T.A. 894 (1932); *Twining* v. *Commissioner* (2 Cir. 1936), 83 F. 2d 954, 17 AFTR 1227.

[68] See "Trading with Related Persons," Section 19.

[69] See *Gummey; Twining* v. *Commissioner*, see footnote 67.

[70] *Helvering* v. *Janney*, 311 U.S. 189, 24 AFTR 1073 (1940); *Taft* v. *Helvering*, 311 U.S. 195, 24 AFTR 1076 (1940).

[71] *Shoenberg* v. *Commissioner* (8 Cir. 1935), 77 F. 2d 446, 16 AFTR 95.

Deductible Losses in Connection with "Wash Sales"	If you purchase the stock		And sell same		Then reacquire the stock		
	On	*For*	*On*	*For*	*On*	*How*	*For*
Substantially identical securities acquired by gift, bequest, or inheritance, within 30 days before or after a "wash sale" loss of similar ones	1/1/54	$5,000	12/15/54	$3,000	1/2/55	By Gift, Bequest, or Inheritance	*
Substantially identical securities acquired within the "wash sale" period upon a tax-free exchange on which gain or loss was not recognized	1/1/54	5,000	12/15/54	3,000	1/2/55	By Tax-free Exchange	$4,000

* Value depends upon manner in which stock is reacquired, that is gift, bequest or inheritance. See Section 5, above, "Basis of Securities."

securities, with his own individual funds, within 30 days before or after the sale by the partnership.[72]

17. Basis of Wash Sale Stock

In the determination of basis for gain or loss, the wash sale loss, which is nondeductible, is added to the basis of the stock or securities the purchase of which caused the disallowance, that is, the new shares; in the determination of date basis, the holding period of the securities purchased in connection with the wash sale is the date of acquisition of the original securities.[73]

Example: Suppose that X buys 100 shares of the Z stock on January 1, 1940, for $10,000. The market declines, and X sells them for $8,000 on January 1, 1955. On January 10, 1955, X buys 100 shares of Z stock for $8,500. The loss (without reference to the fifty per cent rule on long-term gains) is $2,000, and is disallowed; the basis of the new stock is $10,500; and the date basis is January 1, 1940.

Substantial tax savings may result from the proper identification of securities. The wash sale rule may not be applicable to the sale of a security purchased within thirty days of its sale merely because the seller owns another lot of the same security purchased more than thirty days before the sale, if the securities are properly identifiable.

Example: Assume that X buys 100 shares of Z stock on January 1, 1940, and 100 shares of Z stock on January 1, 1955. On January 10, 1955, X sells, at a loss, the stock bought on January 1, 1955. The loss is deductible if X can prove that the stock sold was the lot purchased on January 1, 1955. If, however, it could be shown that on January 10, 1955, he sold the stock acquired in 1940, the loss would be disallowed because on January 1, 1955, within thirty days of the sale, he purchased the identical security.

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[72] See Special Ruling, signed by E. I. McLarney, Deputy Commissioner, dated October 11, 1946, 1947 *Prentice-Hall Federal Tax Service*, par. 76,039.

[73] 1954 IRC § 1091; 1939 IRC § 113(a)(10) and §117(h)(4).

18. "First-in, First-out" Rule

A proper identification is of the utmost importance. The regulations provide that if shares of a corporation are sold from lots purchased at different dates or at different prices, and the identity of the lots cannot be determined, the stock sold shall be charged against the earliest purchases of such stock.[74] This is commonly known as the "first-in, first-out" rule.

The best way to identify lots of stock is by certificate numbers. Obviously, this is impossible if the stock is held in a margin account with a broker. Everything is in a "street name," and a customer is merely a co-owner of numerous certificates in which other customers have an interest. In this situation a taxpayer sufficiently identifies a lot of stock if he instructs the broker to sell the lot bought on a particular date and at a particular price.[75]

Where the taxpayer transfers his stock certificates to the name of a nominee or turns them in to the company in a stock split-up, it has been held that if he keeps records of his certificate numbers and on those records matches the lowest-numbered new certificate with the lowest-numbered old certificate, and likewise matches the remaining certificates in numerical order, he preserves identification.[76] A stockholder can similarly preserve the identification of lots where he receives stock of a new corporation in a tax-free exchange pursuant to reorganization.[77]

19. Trading with Related Persons

The law provides for the disallowance of losses from the sale or exchange of property (other than losses in cases of distributions in corporate liquidations) if the sale or exchange is directly or indirectly between certain related persons. These provisions lay down an exception to the basic principle that any taxpayer may make a bona fide sale or exchange of property at its reduced value to realize a loss.[78] The provisions do not apply to gain transactions. Losses disallowed are those from sales or exchanges of property, directly or indirectly, between:

1. Members of the same family (brothers and sisters of whole or half blood, spouse, ancestors and lineal descendants);
2. An individual and a corporation, if more than 50 per cent of the value of its outstanding stock is owned, directly or indirectly, by or for the individual;

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[74] Reg. 118, Sec. 39.22(a)-8.

[75] *Helvering* v. *Rankin,* 295 U.S. 123, 15 AFTR 1076 (1935).

[76] *Robert E. Ford,* 33 B.T.A. 1229 (1936).

[77] *Bloch* v. *Commissioner* (9 Cir. 1945), 148 F. 2d 452, 33 AFTR 955. But note this anomaly: if identification is not preserved in this situation, the courts have ruled the first-in, first-out rule to be inapplicable. Instead, the cost of the old stock is averaged to find the cost of the new and only one lot of new stock results. *Commissioner* v. *Von Gunten* (6 Cir. 1935), 76 F. 2d 670, 15 AFTR 1206.

[78] 1954 IRC § 267; 1939 IRC § 24(b); Reg. 118, Sec. 39.24(b)-1. See 1954 IRC §§ 165, 1001, 1002; 1939 IRC §§ 23(e), 111, § 112(a).

3. Two corporations more than 50 per cent of each of which is owned, directly or indirectly, by or for the same individual, if either corporation was a personal holding company or a foreign personal holding company during the year preceding the transaction;
4. A grantor and fiduciary of any trust, or the fiduciaries of two trusts created by the same grantor, or the fiduciary and beneficiary of the same trust;
5. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
6. A fiduciary of a trust and a corporation more than 50 per cent in value of the outstanding stock of which is directly or indirectly owned by or for the trust or a grantor of the trust;
7. A person and an exempt charitable or educational organization controlled by the person or, in the case of an individual, by the individual or his family.[79]

In the determination of the ownership of stock under the foregoing provisions, the Code provides that stock owned directly or indirectly by or for a corporation, estate, partnership, or trust is considered as owned proportionately by or for the stockholders, partners or beneficiaries, and that an individual is deemed to own the stock owned directly or indirectly by his family or his partner.[80]

It has been held that where a partnership sold securities at a loss to a corporation 72 per cent of whose stock was owned by the partners, the loss was not deductible by the partnership and neither partner was entitled to deduct his share of the loss.[81] It has been further held that a loss on a sale of real estate by a corporation to two individuals who between them owned 75 per cent of the corporate stock was disallowed when it appeared that they were partners.[82]

Does the statute apply to sales made in the regular course of business on a stock exchange if the security sold is purchased by a related person? The Supreme Court has held that it does.[83] The Court stated that sales on the stock exchange were made "indirectly" by the members of a family; consequently, losses sustained on such sales were nondeductible where the husband, who managed his wife's affairs, ordered his broker to sell certain stock for the account of one of the two, and to buy the same number of shares of the same stock for the other, at as nearly the same price as possible. The Supreme Court reached this conclusion even though the identity of the persons buying from the selling spouse and the persons selling to the buying spouse was never known, and the buying spouse invariably received certificates different from those the other had sold.

Moreover, when one spouse immediately repurchases substantially identical stock or securities, which have been sold at a loss by the other spouse, both Section 267 and Section 1091 may theoretically apply.[84] If a loss under such circumstances is to be disallowed, it would seem to be to the taxpayer's advantage to have it disallowed under Section 1091 inasmuch as the amount of disallowance is added to the basis of the repurchased security. This is not so in the case of a loss disallowed under Section 267.

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[79] 1954 IRC § 267(b). The last 3 categories of taxpayers were not included in § 24(b) of the 1939 Code.

[80] 1954 IRC § 267(c); 1939 IRC § 24(b)(2).

[81] *Commissioner* v. *Whitney* (2 Cir. 1948), 169 F. 2d 562, 37 AFTR 211, reversing on this point 8 T.C. 1019 (1947).

[82] *Homes Beautiful, Inc., et al.,* (1947). Par. 47,166 *Prentice-Hall Memorandum T.C.*

[83] *McWilliams* v. *Commissioner,* 331 U.S. 694, 35 AFTR 1184 (1947).

[84] See *August Kohn, Jr.* v. *Commissioner* (4 Cir. 1946), 158 F. 2d 32, 35 AFTR 351; *McWilliams* v. *Commissioner,* in footnote 83.

The 1954 Code has introduced a new rule for the recognition of gain to the taxpayer upon his disposition of the property if a loss incurred by his transferor is disallowed under Section 267(a) or had been disallowed by reason of Section 24(b) of the 1939 Code. In the event of such a disallowance to the original transferor, and if the taxpayer, after December 31, 1953, sells or otherwise disposes of such property (or of other property the basis of which in his hands is determined directly or indirectly by reference to such property) at a gain, then any such gain will be recognized only to the extent that it exceeds the amount of the loss not previously allowable.[85] This rule does not affect the basis of the property to the taxpayer for determining gain, nor the holding period, and the benefit of the rule is limited to the original transferee.[86]

Example: Father owns securities with a basis of $100,000. He sells them to his son for $75,000. The $25,000 loss is disallowed as a deduction to Father. Son subsequently sells the property for $110,000. His gain of $35,000 (110,000-75,000) is recognized to the extent of $10,000, being the excess of the amount disallowed to Father. Had Son sold for $100,000 or less, no portion of his gain would have been recognized. Had the son exchanged the securities in a tax-free exchange, and thereafter sold the property received in the exchange, any gain to the son upon such sale would be similarly reduced.

If property received by the transferee from the transferor is divisible or consists of several items of property, the transferor's loss is allocated among the properties to determine the amount of gain in subsequent disposition.

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[85] 1954 IRC § 267(d). This subsection does not apply if the loss sustained by the transferor is disallowed because of the wash sales rule under either the current Code (§ 1091) or the 1939 Code (§ 118).

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How to Buy and Sell Real Estate

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The purchase and sale of real property is surrounded by legal procedures and formalities that may easily obscure the ultimate tax effect upon the parties, unless full study is given to the transaction early in the negotiations. In some situations, the type of sale most advantageous to one party may place a heavier tax burden on the other party, and it is important to be able to recognize this fact during the progress of negotiations. This chapter analyzes the tax effects of various realty transfers.

1. Points to Consider

The buying of real estate is not ordinarily a taxable transaction. You will, therefore, not be interested in the immediate tax consequences, but rather in acquiring the property most advantageously, with a view towards operation of the property and ultimate sale. These are the questions you should consider:

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Selling property poses a different set of questions. Here there is the prospect of an immediate tax on the transaction. The emphasis, accordingly, will be on ways of minimizing the tax, or obtaining a maximum benefit from a loss. The following points should be studied:

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2. How to Take Title to Real Property

The first step that has an important effect upon your tax liability is the taking of title to real property. If you take title in a corporate name and later decide that individual ownership is preferable, you may incur an unnecessary tax in liquidating the corporation. It is safer to take title individually in doubtful cases because a subsequent transfer to a controlled corporation may be handled as a tax-free transaction.[1] In the past the corporate form has commonly been utilized because of the potential liabilities that real estate ownership entails. Accidental injuries to persons or property on the premises are the sources of such liabilities. In most cases, however, adequate insurance can be secured, making individual ownership a minimum risk from this viewpoint. The considerations taxwise that will influence the choice of corporate ownership are:

a. How will the corporate tax rate compare with that of the individual one?

b. Is it likely that the corporation would be able to justify retention of earnings?

c. Will the property be managed by an agent, or will the stockholders, as employees, draw salaries?

d. Is there a likelihood of a quick sale and liquidation subjecting the corporation to a tax on the profit, in addition to taxing the stockholders? The 1954 Revenue Code decreased this danger of double taxation. A corporation by adopting and completing a plan of liquidation within a 12-month period may escape tax on gain from the sale of property by it within such period.[2]

e. Will there be any question as to whether you are or are not rightly considered a real estate dealer?

f. If you are a dealer, is this property to be acquired by you as a personal investment?

g. If the property is to be purchased by a syndicate, is it important to have a ready means to dispose of individual interests without sale of the property?

Because of the various types of real estate interests, the form of holding that will most benefit you requires particularly close study. If you are a full time dealer, you may be influenced by the fact that a corporation has a perpetual life. This attribute increases its value as a going business. To you, as an investor, the extent of your other income and the relation of the property to your estate planning will be important factors. If the anticipated income from the property is very high, use of the corporate form will usually result in a substantial saving.

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[1] 1954 IRC § 351; 1939 IRC § 112(b)(5). This section provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation.

[2] 1954 IRC § 337. Prior to the enactment of Sec. 337 the Supreme Court decision in *Commissioner* v. *Court Holding Co., Inc.*, 342 U.S. 331 (1945) attributed a tax to the corporation where it had initiated negotiations for the sale although the actual sale had in form been completed by the stockholders. Justice Black stated, "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." *United States* v. *Cumberland Public Service Co., Inc.*, 338 U.S. 451 (1950), limited application of the Court Holding decision but even under this case the danger of double taxation was extensive.

Syndicates and joint ventures are treated as partnerships for tax purposes. The partnership files an information return only and each partner then reports his share of profit or loss in his individual tax return.

Study the following check list before deciding upon the form of ownership:

TAX COMPARISON OF INDIVIDUAL AND CORPORATE OWNERSHIP

Advantages of Individual Ownership, Joint Venture or Syndicate

Full income tax on earnings of property is paid currently. There is no possibility of double tax.

Greater adaptability is secured in consummating a quick sale. Corporation may not be able to meet the 12-month liquidation test of the 1954 Revenue Code.

Tax on capital gains and losses may be more favorable because of $1,000 loss deduction against other income and holding period percentages.

Joint venture or syndicate may become a member of another partnership. Corporation may not be able to do this.

There is no need to be concerned about ratio of rental income to avoid personal holding company classification.

Tax benefit may result by use of income or losses from other sources as an offset. Especially applicable where property is not income-producing.

Equity in property becomes available for personal uses of the individual. Loans from a corporation may be regarded as taxable dividends.

Carry-over of losses may be applied against other income. Corporation must improve its earnings or the carry-over is lost.

Sale of partnership interest creates a capital gain or loss, limited only by 1954 IRC, Sec. 751, which requires ordinary income tax treatment as to partner's share of unrealized receivables or appreciated stock in trade.

Advantages of Corporate Ownership

The corporate tax rate (particularly if net income is under $25,000) may be substantially below the individual's tax bracket.

There may be business needs that will justify the retention of earnings under 1954 IRC Section 531, and dividends will not be paid.

A dealer using the corporate form can clearly separate his investment holdings.

Shares of individual owners may more readily be disposed of, thereby controlling gains and losses.

Additional mortgage financing after acquisition may be more satisfactorily handled. Where there is sole ownership, individual may be required to go on bond. Corporation can pay bonus for mortgage.

Officers and employees may participate in a pension fund.

If holding unimproved land, corporation can more readily qualify for "business use" under 1954 IRC Section 1231.

Stockholder actively managing the property may be able to justify sufficient compensation so that corporate tax is negligible.

Under 1954 Code if tax liability does not exceed $100,000 corporation pays tax after close of tax year and has use of funds. Individual taxpayer must pay estimated tax at beginning of the year.

3. How to Use a Dummy Corporation

If, in order to avoid personal liability on the mortgage bond or for title recording purposes, you take title in the name of a dummy corporation, you can still escape a corporate tax by restricting the activities of the corporation so that it does nothing more than hold title. Thereafter, all business regarding the property must be carried on individually. The corporation should not enter into any contracts, participate in any financing, make leases, or actively manage the property.[3] As a further protection all insurance policies should cover the principals as well as the corporation.

In order to fully protect the corporation from imposition of tax, the stockholders and directors should adopt a corporate resolution in the following form:

> *Resolved*, that the stockholders and directors of *A.B.C. Corporation* recognize the fact that all the properties standing in the name of *A.B.C. Corporation*, or to which it will have legal title, will not in fact beneficially belong to *A.B.C. Corporation*, but that said corporation is to hold legal title thereto in trust and as agent for *Mr. John Jones* and such person or persons as may have interest by, through or under said *Mr. John Jones;* and recognize also that *A.B.C. Corporation* is under duty to transfer such legal title at such time as said *Mr. John Jones* may direct; and the Board of Directors and officers of said corporation are authorized and employed, in so far as such authority or power may be necessary or advisable, to transfer or cause to be transferred by suitable instruments all or any part or parts of the legal title held by *A.B.C. Corporation* to all properties of any sort, said transfer to be made to the person or persons, corporations or firms as may be instructed or directed by *Mr. John Jones:* the consideration for such transfer being in fact that such properties do not actually belong to *A.B.C. Corporation* but are held by it in trust and as agent for *Mr. John Jones.*

4. Taking Title Jointly with Wife

There are three types of husband and wife ownership: (1) tenancy in common, (2) joint tenancy, and (3) tenancy by the entirety. Under (1) the spouses are co-owners. Under (2) and (3), in addition, the survivor obtains automatic full ownership of the property. A joint tenant may transfer his share during lifetime and thus eliminate the survivorship feature. But this may not be done in a tenancy by the entirety.

Considerations other than tax have often influenced the holding of property as a tenancy by the entirety. The wife does not have an unlimited right to dispose of her interest during the tenancy; the property passes to the survivor without probate proceedings or estate administration, thus removing legal expenses and delays; and the property is not available to individual creditors.[4]

Taxwise, husband and wife ownership formerly had the advantage of dividing income and deductions between the spouses. Since this income-splitting privilege is now available to all taxpayers, the important tax effects of joint ownership relate to gift and estate taxes.

If you do have a tenancy by the entirety, there is an important point with respect to basis that you should note. The 1954 Revenue Code establishes the basis of the property as the fair market value at the date of the decedent's death. Formerly, the survivor's basis for depreciation and upon sale was the cost of the property, not fair market value.[5]

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[3] *Paymer* v. *Commissioner*, 150 F. 2d 334, CCA 2nd (1945); *North Jersey Title Insurance Co.* v. *Commissioner*, 84 F. 2d 898, CCA 3rd (1936); *Moro Realty Holding Corp.*, 25 B.T.A. 1135 (1932); Watson, 42 B.T.A. 52 (1940); *John A. Mulligan, Transferee*, 16 T.C. 1489 (1951); but see *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422 (1949).

[4] *Shaw* v. *U.S.* (D.C. Mich.) (1939), 24 AFTR 1209.

[5] 1954 IRC Sec. 1014. *Lang* v. *Commissioner*, 289 U.S. 109 (1933), 12 AFTR 45.

Where the husband furnishes the entire consideration, taking joint title no longer involves a gift with possible gift tax upon the creation of the tenancy.[6] For the Federal estate tax, if the wife survives, the full amount of the property is included in the husband's estate.[7] But the property is available for inclusion in the marital deduction.[8]

5. How to Assure a Full Deduction for Real Estate Taxes

The 1954 Revenue Code inaugurated a new formula for deduction of real estate taxes assessed during the year in which the sale took place. Effective as to sales after December 31, 1954, the purchaser and seller of real property are to each claim a deduction for that part of the real property tax which is proportionate to the number of days in the property tax year during which he held the property. This applies whether or not the parties to the sale actually apportion the tax.[9] A taxpayer on the cash basis, whether buyer or seller, may claim his proportionate deduction even though he does not actually pay the tax.[10] Where a seller has deducted, for a prior year, real property taxes in excess of his proportionate amount, he must include the excess in gross income in the year of sale. Such excess deduction would be present in a situation where the real estate tax is payable in advance. For example, if the tax is paid March 1st for the tax year March 1, 1954 to February 28, 1955 the owner would take the deduction in his 1954 tax return. If he sells the property January 5, 1955 the buyer is entitled to the tax deduction for the period January 5 to February 28, although he did not actually pay the tax. The seller has therefore taken an excess deduction. Special provisions are applied to an owner on the accrual basis. Instead of accruing the full tax when it becomes a lien the owner may elect to take the accrual ratably over the period for which the tax is imposed.[11] A purchaser assuming and paying delinquent taxes cannot claim a deduction. The purchaser is considered as making such payment to procure an unencumbered title and the payment is part of the purchase price of the property.

6. Purchasing Property with Intention to Demolish

Whether a demolition loss is deductible or must be included as part of the cost of the property acquired depends entirely upon your intent at the time of purchase.[12] If you are buying real property and planning immediately to tear down the existing buildings, in all probability you will not be allowed a loss for the value of the demolished building unless you can show that there was no intent to demolish when you purchased the property. It is possible to establish this if the building is not replaced. If the building is immediately replaced you must show, in addition, that the replacement was not merely for the purpose of putting up a better building but that the useful life of the old building had come to an end. The Regulations provide for a fully deductible loss on demolition of old buildings. But when a taxpayer buys real estate upon which is located a building that he then razes, intending to erect another building in its place, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building. Nor will the taxpayer have a deductible expense on account of the cost of such removal, since the value of the real estate, exclusive of old improvements, is presumably equal to the purchase price of the land and building, plus the cost of removing the useless building.[13] The courts have also held that if a building is demolished in order to make way for a new and better one, no deduction is allowed even if there was no intention to erect a new edifice at the time of purchase.[14] The demolition cost must be depreciated over the life of the new building.[15]

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[6] Reg. 108, § 862; 1954 IRC § 2515(a).

[7] 1954 IRC § 2040, 1939 IRC § 811(e).

[8] 1954 IRC § 2056, 1939 IRC § 812(e)(3).

[9] 1954 IRC § 164(d). Under prior law you could deduct real estate taxes only if you were the owner of the property when the taxes became a liability. The tax attached when it became a lien on the property. Buyer and seller could not by agreement provide for sharing the tax deduction disregarding the lien date and personal liability. Each state and locality provided its own lien dates and imposition of personal liability. If the sale was made during the tax year but before the lien date the practice was to reduce the selling price for the proportionate tax. The entire tax was then paid and deducted by the buyer.

[10] 1954 IRC § 164(d)(2).

[11] 1954 IRC § 461(c). The election may be made when the tax return is filed for the first taxable year beginning after December 31, 1953. Special rules are applied where the taxable year began before January 1, 1954 to prevent double deduction.

[12] I.T. 3311, 1939-2 C.B. 206.

Losses are recognized only when they result from a closed transaction. If a building is demolished because unsuitable for further use, the transaction with respect to the building is closed and the taxpayer may take his loss; but if the purpose of demolition is to make way for the erection of a new structure, the result is merely to substitute a more valuable asset for the less valuable and the loss from demolition is considered as part of the cost of the new asset and to be depreciated during its life.[16] Loss has been allowed where the building was purchased with the intention to use it for a definite purpose, and it was later discovered that, because of latent defects not known to the buyer, it could not so be used.[17] But in a similar situation a loss was disallowed when it appeared that the buyer discovered the defect before the deed was delivered.[18]

Where the demolition was forced by action of the city in widening the street, loss was allowed.[19] It was also allowed where the property was acquired to prevent competition.[20]

Loss has also been allowed where parts of the building were demolished to make way for needed space and facilities.[21]

7. Advantages and Disadvantages of Being a Real Estate Dealer

The question of whether or not you are classified as a "dealer" can have important tax consequences. To a dealer, both gain and loss on sales is ordinary, not capital. Because of the fact that real estate is widely held for investment by taxpayers who do not consider themselves dealers in the commonly accepted meaning of this term, there has been much tax litigation over this question. If buying and selling real estate is your main business, no question arises. The only points to be checked are how to best operate as a dealer. If you are a dealer but are acquiring a piece of property for your own investment, you must be particularly careful to handle the property as indicated below for an investor. Under the present law, by virtue of Section 1231, of the Code, it is generally preferable not to be classified as a dealer, since, to nondealers, gains are capital, and losses may be fully deductible. In addition, a dealer may not make a tax-free exchange under Section 1031(a) of the Code. But there are the following tax advantages enjoyed by a dealer: (a) carry-over and carry-back of losses, and (b) selling commissions may be deducted as business expenses instead of being offset against the selling price.[22]

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[13] Reg. 118, § 39.23(e)-2.

[14] Phipps, 5 T.C. 964 (1945).

[15] *Providence Journal Co.* v. *Broderick* (1 Cir. (1939)), 104 F. 2d 614.

[16] *Commissioner* v. *Appleby* (2 Cir. 1942), 123 F. 2d 700, 28 AFTR 396.

[17] *Parma Co.* 18 B.T.A. 429 (1929).

[18] *Bekins Moving & Storage Co.* (1941), par. 41,560 *Prentice-Hall Memorandum* B.T.A.

[19] *Hartford Courant Co.* v. *Smith* (D.C., Conn.), 30 AFTR 1538, (1942).

[20] *Southern Amusement Co., Inc.*, 14 B.T.A. 300 (1928).

[21] *Steinbach Co.*, 3 B.T.A. 348 (1925).

Who is a dealer? There is no one single test to determine whether you will be classified as a dealer, but the starting point and the best indication is how regularly and how often you buy and sell. If there is no pattern of frequency, you are not likely to be classified as a dealer, because isolated or casual sales do not constitute a business.[23] The manner or the reason for the original acquisition of the property is not determinative. The question after its acquisition is: Was it held for sale to customers in the ordinary course of a trade or business? The test applied is the taxpayer's actual course of dealing.[24] Although the fact that the property was acquired during the course of operation of another business does not exclude the possibility of a dealer classification, it frequently has been a favorable factor.[25]

Study the following table to check your methods of operation:

FACTORS CONSIDERED IN DEALER CLASSIFICATION

These Factors Tend to Make You a Dealer

Devoting full time to buying and selling.

Securing a local or state license.

Membership in state or national associations of realtors.

Using separate corporate entities only where sufficient buying and selling activity can be shown for each taxpayer.

Aiming for relatively quick turnover rather than long-term holding. Long-term holding indicates an investment.

Trading or exchanging has the same effect as selling.

Holding yourself out to the public as a dealer on your stationery, advertising, telephone listing, tax returns, and otherwise.

These Factors Tend to Make You a Nondealer

Not maintaining a sales office or staff.

Being able to show that your intention was to hold the property for investment rather than resale. Intent can only be determined from your statements and acts at the time of acquisition. Preserve all records and memorandum covering the anticipated yield from the property and all other data relating to the soundness of the acquisition from an investment viewpoint. If you have acquired the property in the course of operating another business, this fact would negate an intention of engaging in the real estate business.

Limiting your selling activities, such as

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[22] I.T. 3711, 1945 C.B. 162.

[23] *512 West 56th Street Corp.* v. *Commissioner* (2 Cir. 1945), 151 F. 2d 942, 34 AFTR 404.

[24] See *Wineman Realty Company* (1943), par. 43,136 Prentice-Hall Memorandum T.C.

[25] *Frieda E. J. Farley*, 7 T.C. 198 (1946).

These Factors Tend to Make You a Dealer	*These Factors Tend to Make You a Nondealer*
Subdivision of land is an activity generally associated with a dealer. The 1954 Revenue Code establishes detailed rules for dealers. (See Sec. 10 of this chapter)	sales advertising and development for sale. An investor may sell, but he usually waits until a customer comes along.
	Using separate corporate entities only where doing so concentrates the rental income. Where the taxpayer's principal income is from rents, he is considered an investor.
	Accepting satisfactory offers from unsolicited purchasers.
	Merely passively liquidating investment.

8. How to Find Profit or Loss on a Sale

When selling you will first be concerned with establishing the amount of gain and loss. The basis for sale of real property falls under the general provisions of Section 1012 of the 1954 Code, and is ordinarily cost. If the property was acquired by gift, bequest, or in an exchange, the regular rules of basis apply. Included in cost is the amount of all mortgages, whether or not assumed by you when the property was acquired. Similarly your selling price includes all mortgages whether or not assumed by the purchaser.[26] Mortgages that were given after acquisition will not generally affect the basis.[27] It will often be found that the full cost is not reflected in your ledger accounts. To find the items described below, the original closing statements should be examined and a review made of costs for the entire period during which the property was held.

9. Adjustments to Basis

After you have the initial basis, the next step is to make the specific adjustments to the basis of real property that are applicable under Section 1016 of the 1954 Code. These are the items properly chargeable to capital account that increase the basis: Costs incidental to acquiring title, such as legal fees and recording fees; broker commissions; cost of defending or correcting title; demolition costs not previously deducted; unallowed deductions for abandonment or obsolescence; unamortized expense to secure tenants for the property; architects' services; real estate taxes that were a lien at the time of acquisition but were paid by you.

Permanent improvements form a further important addition to the basis. A check should be made as to whether there is an election to treat taxes or other carrying charges as capital expense under Section 266 of the 1954 Code. This would be particularly applicable to unimproved property that was not income-producing but is not so restricted. The election covers such items as annual taxes, mortgage interest, development expenses and interest on loans made for development or construction.[28]

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[26] *Crane* v. *Commissioner* 331 U.S. 1 (1947), affirming (2 Cir. 1946) 153 F. 2d 504, 35 AFTR 776.

[27] *Marion A. Blake,* 8 T.C. 546 (1947).

[28] Reg. 118, 39.24(a)-6.

The final adjustment, which reduces the basis, is for depreciation. If, as the owner of the property, you sold an easement to which no specific part of the basis could be allocated, the selling price must also be applied in reduction of the basis of the property.[29]

10. Gain or Loss on Subdivision

An entirely new section was contained in the 1954 Revenue Code permitting an individual who is not otherwise a real-estate dealer, to dispose of a tract of real property, held for investment purposes, by subdividing it without necessarily being treated as a real-estate dealer with respect to his gain.[30] Sales activity, such as advertising and expenses of agents, will not in itself deprive the taxpayer of capital gains treatment. The following will, however, cause the property to be considered stock in trade:

a. A holding period of less than five years. If the lot or parcel was inherited, no holding period is imposed other than 6 months to qualify for long-term capital gain.

b. Sales outlays of a permanent nature such as cost of a real-estate office which would be usable for selling other real property could be taken as evidence that the property is being held primarily for sale to customers.

c. If you are engaged in several subdividing activities in one year, you may be held to be a dealer in real-estate on the basis of your activity as a whole.

d. Making substantial improvements indicates a dealer. The test is whether such improvements have been made anywhere on the tract which enhanced the value of the particular lots sold. If, for example, a taxpayer erects a shopping center on a part of a remote tract of unimproved real property and then subdivides and sells the remaining lots, it is most likely that the value of all the remaining lots will have increased. A particular improvement could increase the value of some lots and not others. Permissible improvements, not considered substantial, include clearing operations and the construction of minimum all-weather roads giving access to each lot sold.

e. Only five sales of lots from a single tract may be made as a non-dealer at straight capital gains rates. As soon as the sixth sale is made a special 5 per cent rule is imposed on all prior sales during that year and thereafter. Gain on such sales will be reported as ordinary income up to 5 per cent of the selling price. The remainder of the selling price is taken into account in determining capital gain.

If you are selling a lot or parcel that you have subdivided, in figuring gain or loss, there is a special problem in finding the cost to you. You cannot wait until the cost of the entire property has been returned before reporting income. This is so whether or not you originally intended to subdivide at the time of acquisition. Gain or loss attaches to each parcel or lot sold. Development expenses are added to the cost. The Regulations provide merely that you find the basis for each parcel by an equitable apportionment based upon the entire cost.[31] But the valuation is within your control to the extent that it does not have to be made on the basis of area. Your valuation will be acceptable as long as it takes into consideration comparative values, such as those existing between interior and waterfront lots.[32] Relative assessed valuation is an acceptable basis.[33] Valuation based upon location, usability and quality have also been approved.[34]

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[29] *Inaja Land Company*, 9 T.C. 727 (1947).

[30] 1954 IRC § 1237.

[31] Reg. 118 § 39.22(a)-11; Skinner, 20 B.T.A. 491 (1930).

11. Capital Gains and Losses on Realty

Real property "used in a trade or business" is now specifically excluded as a capital asset. This exclusion covers both land and buildings.[35] However, under a law provision added by the 1942 Revenue Act, if you are not a dealer and if you hold the property for more than six months, special treatment is accorded to net gains on the sale of real property "used in the trade or business." Such gains are taxed as if derived from the sale of capital assets.[36] The practical result with respect to such business property, therefore, is that if you have a net gain, it is capital; if you have a loss, it is fully deductible.

Property is used in trade or business if it is income-producing.[37] An investor obtains this benefit even if he holds only a single piece of property and regardless of the fact that he may actually be engaged in another business.[38] Vacant land held by an investor, since it is not income-producing, appears to be considered non-business property,[39] although the issue has not been directly ruled upon by the courts. But where a business corporation purchased unimproved real estate with the intention of erecting thereon a business building for its own occupancy, an ordinary loss was allowed when the purpose was abandoned and the property sold at the first opportunity.[40]

If you qualify for the special treatment, here are the points to note:

a. The special treatment is applicable only to property held more than six months.

b. Two types of transactions are covered (a) sale or exchange of business property and (b) compulsory or involuntary conversion of business property. This includes condemnation, destruction, and theft.

c. If you have both types of transactions in the taxable year, you must combine them to find out whether there is a net gain.

d. You need not have both gains and losses. If only gains, the losses are treated as zero and the section is applicable.

e. Determine the net gain by using the full amount of gain and loss. Do not reduce by percentages under Section 1202 of the 1954 Code, or loss limitations under Section 1211(b). Only "recognized" gains and losses should be considered. Nondeductible losses and tax-free transactions should be eliminated.

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[32] *Biscayne Bay Island Co.*, 23 B.T.A. 731 (1931).

[33] *Cullinan*, 5 B.T.A. 996 (1927).

[34] I.T. 1843, II-2 C.B. 72.

[35] 1954 IRC Sec. 1221, 1939 IRC Sec. 117(a)(1).

[36] 1954 IRC Sec. 1231, 1939 IRC Sec. 117(j).

[37] *Wright*, 9 T.C. 173 (1947).

[38] *Fackler* v. *Commissioner* (6 Cir. 1943), 133 F. 2d 509, 30 AFTR 932; *Hazard*, 7 T.C. 372 (1946).

[39] *Norton*, (1946) par. 46,105 Prentice-Hall Memorandum T.C.

[40] *Carter-Colton Cigar Co.*, 9 T.C. 219 (1947).

No loss is allowed on sale of property used by the taxpayer as his personal residence. Profit on such a sale is taxed as a capital gain. However, if prior to a sale you rent the property or convert it to income-producing purposes, it becomes business property, and any loss on the sale is fully deductible.[41] Merely moving out of the property and listing it with a broker for sale or rental is not sufficient appropriation.[42] Some additional act is necessary: leasing or renting, remodeling, or any other act that would show a clear-cut intention on the part of the owner to change the character of the property.[43] If an agreement is entered into with a broker for an exclusive rental listing, make certain that the owner is required to accept the rental specified and take care to preclude his resumption of personal use of the property.[44]

Check this table to determine the tax treatment of various types of property:

HOW YOU CLASSIFY REAL PROPERTY GAIN AND LOSS

If the property (held for more than six months) is:	The gain or loss is:
Used by the seller in business	Gain is capital. Loss is deductible in full.
Not used by the seller in his business but producing income	Gain is capital. Loss is deductible in full.
Sold by a dealer	Both gain and loss are ordinary, not capital.
Sold by a broker as an isolated investment	Gain is capital. Loss ordinary.
Purchased by a business company for use but never so used	Gain is capital. Loss is deductible in full.
Vacant lots sold by investor	Both gain and loss are capital.
Residential	Gain is capital. Loss is nondeductible.
Partially used as residence and partially for business	Entire gain is capital. Portion of loss applicable to residence nondeductible. Balance is fully deductible as ordinary loss.
Residential but converted to business use before sale	Gain is capital. Loss is fully deductible.
Residential property acquired by inheritance but never occupied by seller and immediately offered for sale or rent	Gain is capital. Loss is ordinary.
Apartment building sold by investor	Gain is capital. Loss is deductible in full.

12. How to Control Realty Gain and Loss

Real estate transactions, regardless of size, develop many details that must be disposed of before closing title. The year in which gain or loss is incurred may be important to you because of the tax rate or because of offsetting items that might become available. In the contract of sale, the parties may fix the closing date and in this way control the time at which the taxable consequences attach.[45] Postponement of closing date by agreement, when time is not of the essence, is not uncommon. This is often done for such reasons as completion of title search, clearance of objections, necessity for court order in connection with estates and trusts, removal of violations, and obtaining a subordination agreement from a mortgagee.

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[41] Reg. 118 § 39.23(e)-1.

[42] *Morgan* v. *Commissioner* (5 Cir. 1935), 76 F. 2d 390, 15 AFTR 1130; *Rumsey* v. *Commissioner,* (2 Cir. 1936) 82 F. 2d 158, 17 AFTR 577; *Robinson* v. *Commissioner* (3 Cir. 1943), 134 F. 2d 168, 30 AFTR 1183.

[43] *Susan A. Jones* (1944), par. 44,331 Prentice-Hall Memorandum T.C.

[44] *Allen L. Grammer,* 12 T.C. 34 (1949).

[45] *Lucas* v. *North Texas Lumber Company,* 281 U.S. 11 (1930).

These are the key factors to determine when the sale of real property becomes a closed transaction:[46]

a. Passage of title
b. Transfer of possession
c. Exercise of rights of ownership
d. Performance of all conditions precedent
e. Right of seller to recover the purchase price

Passage of title is the most important factor, but there are circumstances in which a sale has been considered as closed before transfer of the deed.[47] If you give possession to the buyer, and there are no conditions to the payment of the purchase price, the transaction may be considered closed.[48] But where the parties provide that certain contingencies must happen or certain conditions be complied with before the sale is completed, such action is effective in postponing taxability to the seller.[49] Provisions of State law declaring that title shall be deemed to have passed upon the occurrence of certain events do not necessarily determine the question for tax purposes.[50]

If a loss is involved, it makes no difference whether you are on the cash or accrual basis. But this question is important where there is a gain. On the accrual basis, the gain *must* be reported in the year the obligation to pay becomes fixed by execution of the contract of sale, regardless of *when* the purchase price is to be paid.[51]

13. Placing Purchase Price in Escrow

By providing in the contract of sale that the purchase price is to be placed in escrow and paid over only on fulfillment of specific conditions, you can postpone the tax until that time, whether you are on a cash or accrual basis.[52] It is preferable here that the escrow agent be an independent party, so that it cannot be claimed that the funds were at all times under the control of the seller.[53] But it is permissible to allow the seller to withdraw the funds upon furnishing a bond satisfactory to the purchaser.[54] The deferment of tax upon an escrow of the purchase price is based upon the fact that further payments are a condition to the passage of title, and, accordingly, the sale is not yet complete.

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[46] *J. T. Wurtsbaugh*, 8 T.C. 183 (1947).

[47] *Commissioner* v. *Segall* (6 Cir. 1940), 114 F. 2d 706, 25 AFTR 698.

[48] *Commissioner* v. *Union Pacific R.R.* (2 Cir. 1936), 86 F. 2d 637, 18 AFTR 636.

[49] *Gilbert Creek Land Company*, 14 B.T.A. 921 (1928).

[50] *Roy* v. *Commissioner* (5 Cir. 1934), 69 F. 2d 786, 13 AFTR 798.

[51] *Helvering* v. *Nibley-Mimnaugh Lumber Company* (D.C. Cir. 1934), 70 F. 2d 843, 14 AFTR 209.

[52] *Bedell* v. *Commissioner* (2 Cir. 1929), 30 F. 2d 622, 7 AFTR 8469.

[53] *Holden*, 6 B.T.A. 605 (1927).

[54] *Glikes* (1935), par. 35,450 Prentice-Hall Memorandum T.C.

14. Giving Option Instead of Sale

Giving the buyer an option to purchase instead of entering into a contract of sale is a recognized method of postponing gain and loss.[55] The seller may protect himself against the contingency of nonexercise of the option by requiring a substantial payment, which would either be credited against the purchase price or forfeited by default. The payment for the option is not income when received. The Tax Court has ruled this to be so, even if the owner has a zero basis.[56] In the event of forfeiture the 1954 Code now provides that the payments may be treated as long-term capital gain in that year provided that the property is a capital asset in the hands of the seller. Under prior law the option payments were considered short-term capital gain.[57]

15. Lease with Option to Purchase

During negotiations both buyer and seller will, as a matter of course, give consideration to whether it is preferable to lease the property rather than make a sale. The advantage to the owner is that although he must report the rent as ordinary income, he may spread it over a term of years, and he may continue his depreciation deductions. The lessee benefits from the right to depreciate improvements over the term of the lease, and by his deduction of rental payments. Under these circumstances, it is sometimes proposed that a lease granting the owner the purchase price in the form of rents, with a reversion of the property to the lessee upon the end of the lease term, be entered into. This is accomplished by giving the lessee an option to purchase at the end of the lease and crediting the rental payments paid over the term against the option purchase price. The use of a lease with option to purchase is not inherently objectionable.[58] But where the parties attempt to use this form to disguise a sale of the property, their deception is revealed by excessive rental payments and inadequacy of the purchase price compared with fair market value of the property at the time the option is exercised. Such transactions will be considered a subterfuge, and the entire profit taxed to the lessor as a deferred payment equivalent to cash.[59] A lease with option to purchase may also be used to convert short-term into long-term capital gain. If you have held the property less than six months a lease with option to buy exercisable by the tenant after the six month period will give you a long-term capital gain.

16. Use of Installment Sale

The use of an installment sale has the advantage of definitely closing the sale without any further conditions or requirements while at the same time deferring tax on part of the profit. Two results may be accomplished by an installment sale. First, the tax incurred may be reduced. Second, payments of such tax may be postponed.

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[55] *Virginia Iron, Coal, and Coke Company* v. *Commissioner* (4 Cir. 1938), 99 F. 2d 919, 21 AFTR 1221.

[56] *Mary P. Hunter* (1943), par. 43,228 Prentice-Hall Memorandum T.C., affirmed 140 F. 2d 954.

[57] 1954 IRC Sec. 1234, 1939 IRC Sec. 117(g)(2).

[58] *Haverstick*, 13 B.T.A. 837 (1928).

[59] A.R.M. 189, I-2 C.B. 68, *A. B. Watson* v. *Commissioner* (9 Cir. 1932), 62 F. 2d 35.

Both of these follow from spreading payment of the purchase price over a period of years, reporting only the profit received in each year. To illustrate, if the purchase price is $50,000, a typical installment contract might provide for five annual payments of $10,000. Assuming the total gross profit to be $20,000, the profit to be reported each year would be $4,000. The income may in this way be subject to lower brackets than if reported in full in one year. You have the option to use the installment method, even if you are a dealer, with respect to each separate transaction.[60] This method may be used whether or not there is immediate passage of title to the property sold.

To qualify as an installment sale the "initial payment" in the year of sale (excluding evidence of indebtedness of the purchaser) may not exceed 30 per cent of the total purchase price. It is not necessary, however, that any payment be made in the year of sale. The 1954 Code eliminated the former requirement that some payment must be made the first year.

To find the "initial payment," include all payments made in the first year, not only the down payment. Where title passes under the contract the following year, both the down payment and all the following year installments are included.[61] But mortgages, whether or not assumed, are not included, except to the extent that they are in excess of the basis of the property to the seller. The amount by which the mortgage exceeds the seller's basis is considered to be the equivalent of cash received and is included as part of the initial payment.[62] Such charges as accrued mortgage interest and taxes assumed by the purchaser but not paid in the year of sale are excluded.[63] If you want to include the mortgage in the initial payment have the purchaser make the payment directly to the mortgagee.[64] If the purchaser is the mortgagee, the full amount of the mortgage is included as part of the initial payment.[65] You can control the amount of the initial payment by escrowing part of the purchase price.[66] Although the initial payment is limited to 30 per cent, as a practical matter you can realize a larger amount by sale of a purchase money mortgage or the buyer's notes, if necessary. Such sales are not considered part of the initial payment.[67] If the seller is a corporation, it may distribute the installment obligations to its stockholders as a liquidating dividend.[68]

The Code does not specify a minimum number of installment payments or restrict the time within which the payments must be completed. However, in arranging an installment sale, bear in mind that although it is no longer necessary to have a payment in the year of sale it is still required that payments be made within each of not less than two years. You do not qualify under a contract that provides merely for a lump sum payment of the total purchase price in a future year.[69] But payment in two years is sufficient to qualify.[70] If you are concerned with the 30 per cent limitation because of the buyer's credit, note that secured notes do not enter into the 30 per cent calculation, even though the security would be part of the calculations if it were part of the consideration.[71]

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[60] G.C.M. 3350, VII-1 C.B. 62 (1928); 1954 IRC Sec. 453(b).

[61] *Newaygo Portland Cement Co.*, 28 B.T.A. 1097.

[62] *Burnet* v. *S. & L. Building Corporation*, 288 U.S. 406 (1933).

[63] *Watson*, 26 B.T.A. 270 (1932).

[64] *Ralph Sterling* v. *Ham*, 3 F. Supp. 386, 12 AFTR 728.

[65] I.T. 2351, VI-1 C.B. 43 (1927).

[66] *Gibbs & Hudson*, 35 B.T.A. 205 (1936) (acq.).

[67] Reg. 118 § 39.44-2.

[68] *Duram Building Corporation* v. *Commissioner* (2 Cir. 1933), 66 F. 2d 253, 12 AFTR 976.

For the purpose of determining what portion of each installment is to be reported as profit, it is necessary to ascertain the "total contract price." For this purpose a mortgage, whether or not assumed, is not included if it is not in excess of seller's cost. For example, if property is sold for $30,000, and the buyer assumes a mortgage of $10,000, the profit on each installment would be calculated as indicated:

$$\frac{\text{gross profit}}{\$30{,}000} \times \text{installment.}$$

In determining "selling price" the amount of any mortgage is included. Commissions and other selling expenses paid or incurred by the seller are not to be deducted or taken into account in determining "initial payment," "total contract price," or the "selling price."

17. Deferred Payment Sales

A deferred payment sale of real estate is one that provides for payment of part of the purchase price in the future, but which does not qualify as an installment sale because of the down payment. The deferred purchase price may be evidenced by notes, or it may consist of a mere promise to pay. On such a sale the fair market value of the notes is the equivalent of cash received. However, the tax advantage here arises from the court decisions holding that a bare promise to pay in the future has no fair market value.[72] Accordingly, under the general rule that the fair market value of property received by the seller is income to him, the tax in such a situation would nevertheless be deferred.[73] If notes are taken which are to be reported at less than face value, they should be nonnegotiable.[74] But even negotiable notes can by proof be established at a value under the face amount.[75] Where notes have been properly taken at no fair market value when received later payment in full is capital gain.[76] But where the note does have a market value (even though less than the face value) any excess subsequently received is ordinary income regardless of the fact that the value previously reported was capital gain.[77] The basis upon which the proceeds of a note having no fair market value when received are treated as capital gain is that the transaction is not closed. If the note has any value at all when delivered this closes the transaction and subsequent payment does not result from the original sale or exchange.

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[69] Reg. 118 § 39.44-2.

[70] G.C.M. 12148, XII-2 C.B. 57.

[71] *Brown Coal & Coke Co.*, 14 B.T.A. 609 (1928).

[72] *Bedell* v. *Commissioner* (2 Cir. 1929), 30 F. 2d 622; *C. W. Titus*, 33 B.T.A. 928 (1936).

[73] Reg. 118 § 39.44-4.

[74] *Dudley T. Hymphrey*, 32 B.T.A. 280 (1935).

[75] *Nichols* v. *Commissioner* (3 Cir. 1930), 44 F. 2d 157; *Harris Trust & Savings Bank*, 24 B.T.A. 498 (1931).

[76] Reg. 118 § 39.44-4.

[77] *A. B. Culbertson*, 14 T.C. 1421.

The promise of an individual purchaser rather than an insurance company to pay an annuity for the property is held to have no fair market value.[78] When purchasing on deferred payments you have the opportunity to create a maximum fully tax deductible interest item. Consider whether a greater benefit may be obtained by decreasing the purchase price and having a higher annual interest charge.

18. How to Sell Mortgaged Property

When you sell mortgaged property, the amount of the mortgage is part of the selling price, whether or not it is assumed by the buyer. Because of this, an owner can become subject to an unexpected tax where his basis is less than the amount of mortgage against it. A sale under these circumstances must be avoided because even a nominal consideration can incur a tax. For example, depreciated cost is $25,000; outstanding mortgage is $30,000. If the property is sold for only $100 cash above the mortgage, there is a gain of $5,100.

If the property is so depreciated in value that there is little or no equity, the most advantageous courses are either to (a) make an offer to the mortgagee of a gratuitous deed or release of interest, if there is no personal liability on the mortgage (where there is personal liability, this will not be effective, since consideration will be presumed where the owner is released from liability on the mortgage),[79] or (b) abandon the property.[80]

If the first course is followed, no attempt should be made to obtain any consideration for the deed—consideration makes the transaction a sale.[81] A conveyance without consideration to a mortgagee is not a "sale or exchange" and accordingly a loss is fully deductible.[82] Under the second alternative, a fully deductible abandonment loss can be obtained, but only if there is clear and definite evidence of abandonment and if the owner's equity is worthless.[83] For tax purposes, an abandonment of land will be recognized even if the state law does not so provide. The act of abandonment is evidenced by refusal to pay further taxes, charging the land off the books as an asset, having no further transactions with respect to it, and exercising no further dominion over it.[84] A full abandonment loss is allowed for a conveyance in satisfaction of a tax lien, if there is no other consideration and there is no personal liability for the taxes.[85]

Where there still is an equity in the property and it is individually held, consideration should be given to transfer the property to a corporation in exchange for all of the capital stock. This would be a tax-free exchange.[86] But since the corporation would take subject to the mortgage, the basis of the stock would have to be reduced by this amount and, therefore, would probably be zero. When the former owner of the property sells the stock, the full amount will be gain. But in this way, only his equity is subject to tax. The difference between his cost and the amount of the mortgage is not.

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[78] *Bella Hommel,* 7 T.C. 992 (1946); *Estate of Bertha F. Kahn* (1947), par. 47,226 Prentice-Hall Memorandum T.C., affirmed (3 Cir. 1949) 130 F. 2d 797.

[79] *Stamler* v. *Commissioner* (3 Cir. 1944), 145 F. 2d 37, 32 AFTR 1440; *Commissioner* v. *Hoffman* (2 Cir. 1941) 117 F. 2d 987, 26 AFTR 486.

[80] Reg. 118 § 39.23(e)-3.

[81] *Blum* v. *Commissioner* (2 Cir. 1943), 133 F. 2d 447, 30 AFTR 929.

[82] *Polin* v. *Commissioner* (3 Cir. 1940), 114 F. 2d 174, 25 AFTR 598.

[83] *Helvering* v. *Alice V. Gordon* (4 Cir. 1943), 134 F. 2d 685, 30 AFTR 1178.

[84] *Denman* v. *Brumback* (6 Cir. 1932), 58 F. 2d 128, 11 AFTR 156.

[85] *William H. Jamison,* 8 T.C. 173 (1947).

[86] 1954 IRC 351, 1939 IRC Sec. 112(b)(5).

19. When to Make an Exchange Instead of Sale

Where business property has appreciated in value, it is possible to postpone the tax by making an exchange rather than a sale. Such an exchange is tax-free,[87] and the basis for the property given is substituted for the property received. This tax postponement, which is not available to dealers, applies only to property held for productive use in trade or business, or for investment. A personal residence is not investment property.[88] The exchange to be "tax-free" must be of property of "like kind." This reference is to the character of the property, and not the grade or quality. City real estate may be exchanged for a ranch;[89] a vacant lot for improved property; a lease for 30 years or more is considered real estate and may be exchanged tax-free.[90] Cash may be received in order to adjust the respective values of the properties, but in such case gain will be recognized to the extent of the cash.[91] An exchange should be made only if it is intended to continue holding the property received. The intention to hold for a sufficient time to reduce taxes, and no longer, is not sufficient.[92]

Where mortgaged property is exchanged, the amount of the mortgages is considered cash received by the transferor, whether or not assumed. Where there are mortgages on both properties, the net mortgage reduction is cash received.[93]

A three-way exchange may be made tax-free. A may trade his property to B in exchange for B's obtaining a transfer to A of other property owned by C. It does not affect A's exchange if B pays C cash for the property or even if he has C convey the property directly to A.[94]

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[87] 1954 IRC § 1031(a); 1939 IRC § 113(a)(6).

[88] I.T. 1587, II-1 C.B. 26.

[89] *George E. Hamilton,* 30 B.T.A. 160 (1934).

[90] Reg. 118 § 39.112(b)(1).

[91] 1954 IRC § 1031(b); 1939 IRC § 112(c)(1).

[92] *Regals Realty Company* v. *Commissioner* (2 Cir. 1942), 127 F. 2d 931, 29 AFTR 444.

[93] *Brons Hotels, Inc.* 34 B.T.A. 376 (1936); *Ebert Estate,* 37 B.T.A. 186 (1938).

[94] *W. D. Haden Co.* v. *Commissioner* (5 Cir. 1948), 165 F. 2d 588.

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Leasebacks

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The great landlords of the Dark Ages bore little resemblance to their vassal tenants. Even the economic and political revolutions of the 18th and 19th centuries had substantially little effect on their unequal positions. It is not until our own era that we see taxation as the really great leveler of our economic, as well as social, strata—of landlords and tenants, of cabbages and kings. Today we often cannot distinguish between them. Our common law still recognizes, for general legal purposes, the separateness of landlord and tenant identities as delineated in deeds and leases, but our tax laws are not great respecters of such formalities.

1. Points to Consider

Section

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What are the tax advantages? 4
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2. What is a Sale and Leaseback Transaction?

One of the anomalous confusions in our interpretations of tax law today arises in situations of sales and leasebacks of real property; that is, where a resident landlord sells his property to a purchaser, and simultaneously gets a long term lease for continuous possession back from the purchaser. Thus, whereas, immediately before the sale he was a landlord in possession of the premises, immediately after the sale he becomes a tenant in possession of the same premises, with a long term lease to protect his possession. Why a landlord should wish to change his status to that of a tenant, and why the tax law should refuse in some situations to give cognizance to such nefarious change, constitute an entire body of tax litigation and interpretation.

3. What are the Business Advantages?

The landlord who chooses to become a tenant under a long term lease often does so with mixed motives. First, he may sell his property to improve his liquidity. With the monies realized from the sale, he may be able to expand his business further; or he may wish to retire some loans; or he may desire, or even need, to improve his credit standing by increasing his working capital and reducing his fixed assets. Sometimes, as happens in large corporations, it may be desirable merely to improve the appearance of the balance sheet for the consumption of stockholders and the security buying public. Illusory as this change may be, stock market quotations have fluctuated for much less reason than a balance sheet switch from fixed assets to current assets resulting from a sale of real estate.

It may be pointed out that liquid capital may be raised by many means other than sales of fixed assets; for example, by stock and bond flotations, or by bank loans. It might also be indicated that investors and business people may not be deluded by transactions engaged in for mere balance sheet appearance improvement. It might further be stated that when fixed assets must be sold to maintain good credit relationships, there are apt to be even more serious credit problems ahead. Be that as it may, different business entities each solve their financial headaches in their own separate ways, and no outsider can properly evaluate the precise motive and intent of any solution sought. That it may be good or bad business judgment to take some particular tack is merely a matter of opinion. What in prospect may appear to be good judgment is often proved in retrospect to have been bad.

4. What are the Tax Advantages?

Business techniques that result in increased tax liabilities are of no interest to the Commissioner of Internal Revenue. However, sale and leaseback transactions often carry with them certain tax as well as business advantages, and this casts a doubt on the propriety of the entire device.

One of these tax advantages lies in the fact that a taxpayer who sells property subject to a leaseback, usually obtains a larger rent deduction as a tenant than he did a depreciation deduction as a landlord. Depreciation is computed on the basis of buildings and improvements, while rent is measured and paid for use of the land as well as the buildings and improvements. The rent deduction is therefore apt to be larger than the depreciation deduction. This tax benefit carries with it a mixed blessing. On the one hand, it should be borne in mind that the larger rent deduction arises from an actual immediate cash payout for rent, while the depreciation deduction is more in the nature of a bookkeeping entry. On the other hand, where there is a sale of the building, the cash position of the seller-lessee is immediately enhanced to the extent of the bulk cash received on the sale, and then the periodic rent payments gradually and slowly deplete the cash position. The rent deduction might be substantially more than the depreciation deduction for another reason, namely, that the term of the lease may be considerably shorter than the life expectancy of the property. Thus, where unusually good business conditions are currently present, with perhaps an excess profits tax with which to contend, and a slowdown in business is anticipated several years hence, a short term lease at a high rental might result in a large rental deduction in lush years.

A good business man might be inclined to assume that any one, or any combination of the advantages discussed, for engaging in a sale and leaseback transaction, would be a matter for him to determine. But, unfortunately, when tax advantages are deliberately or coincidentally obtained, his business policies are subject to the close and careful scrutiny of the Commissioner of Internal Revenue and the courts; and these erudite bodies are not always in agreement with his business views.

5. Rent as a Tax Deduction

a. What do the cases say? By and large, the courts have been much more taxpayer minded in their determinations in the area of sale and leaseback transactions than they have been in many other areas of taxability. They have scrutinized carefully the arm's-length nature of such transfers, and where a fair selling price has been set on the property, and a fair and reasonable rent has been charged, they have generally allowed the rent deduction.[1]

On the other hand, where the transfers of the property have been sham in nature, and where the selling price and rental have deviated from the market price, the courts have made short shrift of these situations.[2]

In one situation where there was a transfer of property by a family partnership to a trust for the benefit of the minor children of the partners, with a leaseback to the partnership, the court held that there was a valid transfer, that the trust acquired real ownership with all the incidents thereto, and that the rent deduction was a valid one.[3] On the other hand, in a case where the partners of the purchasing entity were the same people as the stockholders of a selling corporation, and where the lease agreement stripped the purchaser of all incidents of ownership except bare legal title, the court refused to go along and disallowed the rent as a deduction.[4]

b. What are the criteria for rent as a tax deduction? We may assume the courts will allow the rent deduction in the case of a sale and leaseback where, (1) the selling price is reasonable, (2) the rental is fair and reasonable, (3) the purchaser and seller have dealt at arms length, and (4) the sale results in the transfer of all incidents of ownership, not bare legal title.

At this point it might be well to indicate that these criteria are set up as a result of court decision rather than under the Internal Revenue Code. The Revenue Act of 1954, therefore, has little bearing or effect upon sale and leaseback transactions.

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[1] *Standard Envelope Manufacturing Co.* 15 T.C. 8 (1950); A. A. *Skemp* (7 Cir. 1948) 168 F. 2d 598, 36 AFTR 1089; *Albert T. Felix* 21 T.C. 90 (1954).

[2] *Catherine G. Armston* (5 Cir. 1951) 188 F. 2d 531, 40 AFTR 460; *Henry Kirschenmann* (D.C., S.D. Calif. 1952) Div. No. 853, 854; *Riverpoint Lace Works, Inc.* T.C. Memo 1954-39

[3] *Helen C. Brown* (3 Cir. 1950) 180 F. 2d 926, 39 AFTR 1089.

[4] *Shaffer Terminals, Inc.* (9 Cir. 1952) 194 F. 2d 539, 41 AFTR 847.

6. Loss Deduction on a Sale

A much greater and more immediate tax saving than that resulting from the rent deduction, relates to the feasibility of deducting a loss on a sale of real estate with a leaseback provision. However, here the courts have been less generous in allowing the deduction.

a. What do the cases say? In one Tax Court decision,[5] the court allowed the deduction of a loss on the sale where the facts made it almost impossible to do otherwise. This was a situation where the selling price of the property was higher than an appraisal valuation of it, where the rent was reasonable, where the term of the leaseback was for only twenty years, and where there was a real and unequivocal transfer of the ownership and control of the property. However, in another case which went to the Circuit Court and now stands as law, the loss deduction was denied.[6] In this situation, the court took the position that there was no sale of real estate but a mere exchange of property for other property of like kind. The leasehold was for a period of not less than twenty-five years, or more than ninety-five years, at the option of the seller-lessee. Under the Regulations,[7] a lease for thirty years or more is defined as of "like kind" to real estate; and since this transaction constituted an exchange of property of like kind, no loss on the exchange could be deducted. It might be well to point out that the regulations referred to are those in effect before the 1954 Revenue Act. The new regulations under this Act have not as yet been promulgated.

b. What are the criteria for deducting a loss on sale? It would appear at the present time that a loss may be deducted on a sale of real estate with a leaseback provision where, (1) there is a real transfer of ownership, (2) there is a real change in the economic position of the seller, (3) the selling price is reasonable, (4) the rental is reasonable, and (5) the leasehold is clearly for a term of less than thirty years. If all of these prerequisites are met, the best that can be said is that a loss on the sale *may* be allowed.

7. Conclusion

Whatever the reasons, and however great the business urgencies may be to induce a sale and leaseback transaction, the potential tax advantages should be viewed as a deterrent rather than a stimulant to such a transaction. As often happens, the tax advantage is utilized at a time when it is financially of no great consequence. If, thereafter, a tax deduction is disallowed for rent or for a loss on sale, it may prove embarrassing to explain to stockholders, or it may occur at a time of financial stringency. A sale and leaseback arrangement should therefore be entered into with a full awareness of the hazards and uncertainties that surround any tax benefit transaction.

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[5] *May Department Stores Co.* 16 T.C. 547 (1950).

[6] *Century Electric Company* (8 Cir. 1951) 192 F. 2d 155, 41 AFTR 205.

[7] Reg. 118 § 112(b)(1)-1.

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How to Save Taxes in Mortgage Foreclosures, Settlements Between Mortgagor and Mortgagee, and Related Transactions

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Importance and Purpose of this Discussion

In effecting a revision of the antiquated Federal tax laws, in 1954, the House of Representatives proposed substantial and sweeping changes in the law regarding the taxation of gain or loss on mortgage foreclosures, as well as the rules for determining the basis of the foreclosed property (Sec. 1035 of the House bill).

The Senate rejected the House's proposals saying (through its committee):

> The approach under the House bill provided that in the case of foreclosures no gain or loss would be recognized until the creditor disposed of the property. Under this treatment, the foreclosed property would take the debt as its tax basis, and the gain or loss on its ultimate disposition by the creditor would be capital or ordinary, depending on the previous character of the mortgage or other evidence of indebtedness in the hands of the creditor. The action of your committee in this regard [in rejecting these changes proposed by the House] was governed by the concern expressed by various taxpayer groups that the proposed House treatment in its application to the complex area of creditor-debtor relationship might operate so as to unduly defer or in some cases deny appropriate loss deductions. In eliminating this provision, the committee has restored present law, which in general treats a mortgage foreclosure as a taxable sale and determines the gain or loss with reference to the difference between the value of the foreclosed property and the portion of the loan satisfied by the foreclosure.

So, by the Senate's refusal to change or codify the tax law relating to mortgage foreclosures, the numerous problems and "gray areas" remain.

However, the disastrous tax consequences that sometimes follow the foreclosure and settlement of mortgages may be avoided by proper advance planning as to the procedure to be followed in mortgage transactions. In addition to an outline of the circumstances under which the owner of mortgaged property and the mortgagee will sustain a taxable loss or gain as a result of a compromise settlement or foreclosure of a mortgage, this discussion includes a list of recommended methods for avoiding unnecessary income taxes in such transactions.

The discussion will be divided into two main parts, the first embracing the tax problems and recommended procedures in regard to the mortgagee, and the second in regard to the owner of mortgaged property.

1. Points to Consider

Assume that your client is a mortgagee, and has realized a gain in a mortgage transaction. You are faced with finding the most satisfactory tax position for him. You must consider:

	Section
Did the gain result from a compromise with the owner?	2
Did the gain result from a foreclosure?	3

On the other hand, suppose that the mortgagee sustained a loss in a mortgage transaction. In view of the fact that foreclosures are time-consuming and expensive, mortgagees usually prefer to compromise with the owner of mortgaged property rather than to resort to foreclosure. The compromise usually assumes one of two forms, namely, reduction of the mortgage debt, or surrender of the mortgaged property to the mortgagee. Your problem as to the loss to the mortgagee will concern itself with the following questions:

	Section
Did the loss result from a voluntary reduction of the mortgage debt?	4
Did the loss result from an acceptance of a surrender of mortgaged property?	5
Did the loss result from a foreclosure rather than from a compromise?	6

In view of the unsettled state of the law with reference to taxable gain or loss to the mortgagee, certain procedures upon foreclosure should be followed carefully by the mortgagee.

	Section
What recommendations can be submitted as to the procedures to be followed by the mortgagee upon foreclosure?	7

Next, assume that your client is the owner of mortgaged property, and has sustained a gain in a mortgage transaction. You are faced with finding the most satisfactory tax position for him. You must consider:

	Section
Did the gain result from a compromise with the mortgagee?	8
Did the gain result from a foreclosure?	9

On the other hand, suppose that the owner of the mortgaged property sustained a loss in a mortgage transaction. Your problem will concern itself with the following questions:

	Section
Did the loss result from a surrender of the mortgaged property to the mortgagee?	10
Did the loss result from an abandonment of the mortgaged property?	11
Did the loss result from a foreclosure?	12

Foreclosures and compromises of the mortgage debt may result in an avoidable taxable gain, or a capital loss rather than an ordinary loss, or a nondeductible loss to the owner of the mortgaged property. Such tax results may be avoided by careful planning of procedure in the mortgage transaction:

Section
What recommendations may serve to assist the owner of mortgaged property in properly handling foreclosures and compromises of the mortgage debt? 13

2. Mortgagee's Gain on Compromise with Owner

When the mortgagee accepts a surrender of the mortgaged property in cancellation of the mortgage debt, the mortgagee may realize taxable income to the extent that the fair market value of the property acquired by the mortgagee exceeds the basis of the mortgage debt that is cancelled.[1] As this is *not* a sale or exchange,[2] the gain would *not* be a capital gain under 1954 IRC § 1222, 1939 IRC § 117(a)(4), but rather would be ordinary income as a "disposition" under 1954 IRC § 1001(a), 1939 IRC § 111(a).

At the time the mortgagee compromises with the owner by accepting the mortgaged property in cancellation of the mortgage debt, interest on the mortgage is ordinarily past due and unpaid. This accrued interest is taxable to the extent that it is paid. That is, it is taxable to the extent that the value of the property acquired by the mortgagee exceeds the principal due on the mortgage.[3]

A mortgagee's gain or loss upon re-possession by the mortgagee under an installment sale obligation is covered by 1954 IRC § 453(d), 1939 IRC § 44(d), and Reg. 118, § 39.44-1.

3. Mortgagee's Gain on Foreclosure

Reg. 118, § 39.23(k)-(3) provides that if the mortgagee buys in the mortgaged property at the foreclosure sale for less than its fair market value, "gain is realized" to the mortgagee

> . . . measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned to him) and the fair market value of the property. The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer in the absence of clear and convincing proof to the contrary. If the mortgagee subsequently sells the property so acquired the basis for determining gain or loss is the fair market value of the property at the date of acquisition.

Although the Board of Tax Appeals had difficulty at one time in finding a "sale or exchange" in this situation,[4] the Tax Court, in the *Hardwick* case[5] followed and applied this regulation to a situation where the mortgagee bid in the mortgaged property for $10,800 less than its fair market value. This amount was taxed to the mortgagee as a capital gain on the theory that the transaction amounted to "an exchange of mortgage obligations for the mortgaged property . . . which comes squarely within the scope of the Regulation." [6] It thus appears the Tax Court will apply this Regulation in the future although the question of taxable gain to the mortgagee as a result of acquisition of the property upon foreclosure is still unsettled.

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[1] *Commissioner* v. *Sisto Finance Corp.* (2 Cir. 1943), 139 F. 2d 253, 31 AFTR 1046; *Clarkson*, 46 B.T.A. 688 (1942); *Puelicher*, 6 T.C. 300; Montgomery, *Montgomery's Federal Taxes*, New York, Ronald Press Company, 1952, Vol. 1, p. 497.

[2] *Hale* v. *Helvering* (D.C. Cir. 1936), 85 F. 2d 819, 18 AFTR 520.

[3] *Helvering* v. *Missouri State Life* (8 Cir. 1934), 78 F. 2d 778, 16 AFTR 473; *Manufacturers Life Ins. Co.*, 43 B.T.A. 867 (1941).

[4] *Henschel*, B.T.A. Memo, April 30, 1938. Dkt 83783.

[5] *Hardwick*, par. 47,060, Prentice-Hall Memorandum T.C. (1947).

Mortgagee's gain from accrued interest on foreclosure. If the mortgagee bids in the property at the foreclosure sale for the full amount of principal plus unpaid interest due on the mortgage (which frequently happens), the interest is not taxed to the mortgagee as income under Reg. 118 § 39.23(k)-(3). In such case, under this Regulation, the mortgagee sustains a gain or loss, as the case may be, of the difference between the amount of the mortgage debt applied to his bid and the fair market value of the mortgaged property bid in by him. Considerable confusion was created on this point, however, by the decision of the Supreme Court of the United States in *Helvering* v. *Midland Life Insurance Co.*[7] The Court upheld a tax upon the accrued interest as ordinary income, even though the fair market value of the property was less than the *principal* due on the mortgage. The Court considered the *bid* price to be conclusive and refused to consider the fair market value of the mortgaged property. This is harsh law. It taxes the mortgagee with interest income it has not received either in cash or property value. This case warrants a somewhat extended discussion because the Supreme Court has never reversed itself on this point.

Criticism of this decision is almost unanimous. A dissenting opinion in the same case criticized it as follows:

> To support the assertion that here the mortgagee collected interest, when in fact everything received was worth less than the sum loaned, requires resort to theory at war with patent facts. The mortgagee got nothing out of which to pay the enactment (i.e., the income tax); its assets were not augmented. Like imaginary "receipts" of interest often repeated and similarly burdened would hasten bankruptcy. Divorced from reality, taxation becomes sheer oppression.

Randolph Paul tersely states the inequity that will result if the *Midland* doctrine ultimately prevails over the Regulation, as follows:[8]

> The confusion which may arise if the Regulation be finally upset as being in contravention of the *Midland Mutual Life* case is easily imagined. If a mortgagee resells property bid in upon a foreclosure for more than the foreclosure bid price, he may be taxed upon the difference between his reselling price and the bid price, although he may already have been taxed upon the excess of the fair market value of the property at the time of the foreclosure over the bid price. On the other hand, if he resells the property for less than the foreclosure bid price, the mortgagee may be entitled to a loss, although he has already been allowed a loss equal to the excess of the amount of his bid over the fair market value of the property at the time of the foreclosure.

The Court rejected the argument that the mortgagee could actually receive no interest income unless the fair market value of the property equalled the principal and interest due on the mortgage, on the following grounds:

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[6] *Huey & Phillips Hardware Co.*, 40 B.T.A. 781 (1939); *Manufacturers Life Ins. Co.*, 4 T.C. 811 (1945).

[7] 300 U.S. 216, 18 AFTR 114 (1937).

[8] Randolph Paul, "Federal Income Tax Problems of Mortgagors and Mortgagees," 48 *Yale Law Journal* 1315, 1329, 1330.

> The administration of the income tax law would be seriously burdened if it were held that when a mortgagee bids in the property for a sum including unpaid interest, he may not be taxed on the interest received except upon an inquiry into the probably fair market value of the property. At best, evidence of value is largely a matter of opinion, especially as to real estate.

So this decision *may* ultimately mean that the market value of mortgaged property is of no consequence in determining the tax liability of the mortgagee on foreclosure, and that the bid price alone is to be considered. If so, unfairness to mortgagees may result, because the market value of the property is all a mortgagee actually receives when he bids in the property. The bid represents merely a fictitious valuation.

However, it is likely and to be hoped, that this unusual decision was reached, and the Regulation ignored, because the mortgagee in that case was a life insurance company, as to which the opinion states, "The general provisions of the Revenue Acts concerning capital 'gains and losses' and 'bad debts' are not applicable." This theory is strengthened by the fact that the opinion does not mention the Regulation, possibly because the Court did not find it applicable to life insurance mortgagees.

The *Midland* case has caused considerable confusion in lower court decisions as to the circumstances under which a mortgagee realizes a taxable gain on foreclosure. A short summary of a few of these cases may help foretell whether the Supreme Court will eventually apply the *Midland* doctrine to mortgagees other than life insurance companies and thus invalidate Reg. 118 § 39.23(k)-(3).

In 1940 the First Circuit, in the *Hadley Falls* case[9] refused to apply the doctrine of the *Midland* case and upheld the Regulation. There the mortgagee bid in the mortgaged property on foreclosure for $56,000. The fair market value of the property was only $49,200. The mortgagee claimed the difference, $5,800, as a capital loss. The Commissioner contended:

1. That the mortgagee had "purchased the property at foreclosure sale" and that no loss is allowable on a "purchase" of property.
2. That the *Midland* case precludes any deduction based upon the value of mortgaged property acquired by a mortgagee.

The Court overruled these contentions on the following grounds, respectively:

1. The transaction was an "exchange" of the mortgage debt for the property.
2. The Regulation was not before the Court in the *Midland* case because it was not applicable. Had it been, it would have been upheld.

In so holding, the Court used the following cogent reasoning:

> The only question before the Court in the *Midland* case was whether an insurance company should include in its gross income, as interest, the amount of interest included in the bid price for real estate acquired by it at foreclosure sale, the fair market value being less than the bid price. The Court held that the interest was taxable income. . . .
>
> Mr. Justice Brandeis, in his opinion in the *Midland* case, points out that the administration of the income tax law would be severely burdened if it were necessary to inquire into the fair market value when a mortgagee bids in property for a sum including interest.

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[9] (1 Cir. 1940), 110 F. 2d 887, 24 AFTR 800.

Although the language of the Court is very broad, we cannot believe that it was intended to preclude examination into the fair market value of property under all circumstances, especially in a case where the agency required to engage in the process of valuation, viz., the Treasury Department, has itself been responsible for the rule making valuation necessary. We do not see why an interpretive regulation requiring the Treasury Department to engage in valuation should not be treated just like any other regulation interpreting a statutory provision. Upon reenactment of the statute without change, such a regulation should be given the force and effect of law. Surely if the Supreme Court had been faced, in the *Midland* case, with a statutory provision making determination of the fair market value necessary, it would not have disregarded such a mandate.

In 1944 the Sixth Circuit in the *Nichols* case,[10] applied the Regulation and refused to follow the *Midland* case on the ground, among others, that the doctrine announced in the *Midland* case applies only when a life insurance company is the mortgagee. In the *Nichols* case the mortgagee's bid was sufficient to include the principal of the mortgage plus $86,000 accrued unpaid interest. The Commissioner contended that this interest should be taxed as ordinary income to the mortgagee under the *Midland* doctrine, even though the value of the property was less than the *principal* due on the mortgage. The Tax Court sustained the Commissioner and disregarded the Regulation. The Circuit Court of Appeals reversed the Tax Court and held that the accrued interest was not income; that the Regulation is valid; and that under the Regulation the mortgagee should be allowed a capital loss equal to the difference between the basis of the mortgage applied to the bid, $155,000, and the value of the property acquired by the mortgagee, $72,000, or a loss of $83,000.

The Tax Court decisions are not in harmony as to whether the *Midland* doctrine or the Regulation prevail when gain to the mortgagee is involved.

In *Clarkson Coal Co.*,[11] decided in 1942, the *Midland* doctrine was applied to a mortgagee that was not a life insurance company. There the mortgagee bid in mortgaged property for $62,000 and applied to the bid mortgage bonds which cost the mortgagee $40,000. The difference of $22,000 was taxed to the mortgagee as a gain and payment of interest, under the authority of the *Midland* case, without reference to the value of the mortgaged property, as required by the Regulation.

In *Nichols*,[12] decided in 1943, the Tax Court applied the *Midland* doctrine, but was reversed by the Circuit Court of Appeals.[13]

In the *Hardwick* case,[14] decided in 1947, the Tax Court applied the Regulation and quoted with approval the *Hadley Trust Company* case[15] which practically nullifies the effect of the *Midland* case by limiting its application to life insurance mortgagees.

The Commissioner has not seen fit to appeal to the Supreme Court any of the decisions which limit the application of the *Midland* case to life insurance mortgagees. Until the Supreme Court clarifies this subject, there is danger that the *Midland* doctrine will ultimately be applied to all mortgagees. The adverse effect of this doctrine may be avoided by utilizing the first of the recommendations to mortgagees in Section 7 of this Chapter.

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[10] (6 Cir. 1944), 141 F. 2d 870, 32 AFTR 507.

[11] 46 B.T.A. 688 (1942).

[12] 1 T.C. 328 (1943).

[13] See text at footnote 10.

[14] See footnote 5.

[15] See footnote 9.

4. Mortgagee's Loss on Reduction of Mortgage Debt

Mortgaged property may depreciate in value until the property is not worth as much as the balance due on the mortgage. Moreover, the mortgagor may be financially unable to pay the full amount of the mortgage. In such cases the mortgagee sometimes allows the owner to retain the property and accepts less, in cash or in property, than the full amount due on the mortgage, in full or partial satisfaction of the mortgage debt.

The Bureau has ruled that under such circumstances, there is no sale or exchange and that the amount of the debt cancelled may be deducted as a bad debt (under 1954 IRC § 166; 1939 IRC § 23(k)) by the mortgagee, provided it is uncollectible.[16] Sec. 166 of the 1954 Code allows a full deduction for bad debts "incurred in the taxpayer's trade or business" or "created or acquired (as the case may be) in connection with a taxpayer's trade or business," but allows only a deduction as a short-term capital loss for "non-business" bad debts. While under the 1939 Code[17] the character of the debt at the time it became worthless was important, the 1954 Code abolishes this distinction. A "non-business" bad debt must be entirely worthless before any deduction is allowed under 1954 IRC § 166(d)(1)(B), (1939 IRC § 23(k)(4)) while a deduction for partial worthlessness may be taken for a business bad debt.[18]

The restrictions concerning deductions for "non-business" bad debts do not apply to corporations, because corporations are specifically excluded from the provisions of Sec. 166(d) (Non-business debts) by 166(d)(1).

The Code prevents a mortgagee, other than a bank,[19] from deducting as a bad debt a loss resulting from the worthlessness of a mortgage when the mortgage debt is evidenced by a "bond, debenture, note or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof with interest coupons or in registered form." In such case any gain or loss resulting is made a capital gain or loss by the Code.[20]

If the mortgagee's loss is deductible only as a "non-business" bad debt, because he is an individual, there is the possibility of obtaining a deduction of the loss in full as a "loss incurred in a transaction entered into for profit" under 1954 IRC § 165(c)(2) (1939 IRC § 23(e)) or under other provisions of the Code.[21]

Where the mortgagee in consideration of immediate payment of the mortgage accepted less than the principal sum, the difference was an ordinary loss to the mortgagee under 1954 IRC § 165(c)(2) (1939 IRC § 23(3)(2)) of the Code even though the mortgagor was fully able to pay the entire amount of indebtedness.[22]

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[16] I.T. 3121, 1937-2 C.B. 138; I.T. 3548, 1942-1 C.B. 74; *Hale* v. *Helvering* (D.C. Cir. 1936), 85 F. 2d 819, 18 AFTR 520.

[17] Reg. 111 § 29.23(k)-6; 2 Prentice-Hall 1953 Federal Tax Service, par. 13,924-A.

[18] 1954 IRC § 166(a)(2); 1939 IRC § 23(k)(1).

[19] 1954 IRC § 582(a); 1939 IRC §§ 23(k)(2) and 117(i).

[20] 1954 I RC §§ 165(g)(1) and (2) and 166(e); 1939 IRC §§ 23(k)(2) and (3).

[21] *Bowles Lunch, Inc.* v. *U.S.*, 91 Ct. Cls. 292, 33 F. Supp. 235, 25 AFTR 212 (1940).

[22] I.T. 4018, 1950-2 C.B. 20.

If the deduction is allowable under the "loss provision," the loss must be realized within the taxable year.

5. Mortgagee's Loss on Surrender of Mortgaged Property by Owner to Mortgagee

It is not unusual for a mortgagee to sustain a loss by accepting a conveyance or surrender of the mortgaged property from the owner in full or partial satisfaction of the mortgage debt. The present view of the Bureau in such event is that the excess of the basis of the mortgage satisfied over the fair market value of the property surrendered to the mortgagee may be deducted by the mortgagee as a bad debt.[23] This view is not altered by the fact that the transaction may constitute a gift to the debtor under the rule first announced in the leading *American Dental* case discussed later,[24] or a "sale or exchange" insofar as the debtor is concerned.[25]

History of the Bureau ruling. Formerly the Bureau held that when an owner surrendered mortgaged property to the mortgagee in satisfaction of the mortgage debt, the transaction constituted a "sale or exchange" of the mortgage debt for the property, and that, therefore, the mortgagee's loss was a capital loss.[26] The courts disagreed.[27] The significant reasoning of the courts was that "no sale or exchange" usually results when a mortgagee surrenders and cancels a mortgage note in consideration of a conveyance of the mortgaged property to the mortgagee, because the note is "extinguished," and not "sold or exchanged." Finally, in 1942, the Bureau reversed its former ruling and adopted the ruling noted above[28] to conform to the court decisions.

Mortgagee's basis of property acquired from owner by compromise. The foregoing ruling of the Bureau also provides that when the mortgagee "accepts a voluntary conveyance of property, including property pledged as security for the debt, in partial or in full satisfaction of the unpaid portion of the indebtedness" and "the property so acquired is subsequently sold" the basis for determining gain or loss is the fair market value of the property at the date of acquisition "by the mortgagee."[29]

6. Mortgagee's Loss on Foreclosure

When a mortgagee forecloses, the highest bidder at the foreclosure sale must of necessity be either the mortgagee or a third party. We will discuss the situation where the *mortgagee* is the successful bidder. There are several steps in determining the mortgagee's loss on the foreclosure under Reg. 118 § 39.23(k)-(3), which provides as follows:

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[23] I.T. 3548, 1942-1 C.B. 74; *Bingham* v. *Commissioner* (2 Cir. 1939), 105 F. 2d 971, 23 AFTR 287; *Spreckels* v. *Commissioner* (9 Cir. 1941), 120 F. 2d 517, 27 AFTR 474.

[24] Compare *Adam* T.C. Memo Dkt. No. 1720, 6/28/44, with *Cocheco*, T.C. Memo Dkt. No. 4175, 6/28/45.

[25] *Hale* v. *Helvering* (D.C. Cir. 1936), 85 F. 2d 819, 18 AFTR 520; *Commisioner* v. *National Bank of Commerce* (5 Cir. 1940), 112 F. 2d 946, 25 AFTR 303; I.T. 3548, 1942-1 C.B. 74; also, see cases in Footnote 23.

[26] I.T. 3121, 1937-2 C.B. 138.

[27] See footnote 23; 1954 Prentice-Hall Federal Tax Service, par. 5652.

[28] I.T. 3548, 1942-1 C.B. 74 (1942).

[29] See footnote 28.

> If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the portion of the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, the mortgagee or pledgee may deduct such amount (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it has become wholly worthless or is charged off as partially worthless. In addition, if the creditor buys in the mortgaged or pledged property, loss or gain is realized, measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property. The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer in the absence of clear and convincing proof to the contrary. If the creditor subsequently sells the property so acquired, the basis for determining gain or loss is the fair market value of the property at the date of acquisition.
>
> Accrued interest may be included as part of the deduction only if it has previously been returned as income.

Under this Regulation, if the *mortgagee* bids in the property at the foreclosure sale for less than the mortgage debt, and the balance is uncollectible, *the first step* for the mortgagee to take is to deduct this uncollectible balance as a bad debt.[30] As the bad debt deduction depends on worthlessness or partial worthlessness of the deficiency, legal action (such as deficiency judgment proceedings) should be instituted toward recovering the deficiency. But the completion of this first step does not close the foreclosure proceedings for tax purposes. As a matter of fact, the real complications begin here, where *the second step*, which follows, commences.

The second tax deduction provided for by the foregoing Regulation is as follows: If the amount of the mortgage debt which the mortgagee applies to his bid (usually the amount of the bid) is more than the value of the mortgaged property, the mortgagee may deduct the difference as a loss.

Under this *second step*, the mortgagee's loss or gain will be a capital loss or gain, if the mortgage is a capital asset of the mortgagee; otherwise it may be an ordinary loss.[31]

In determining whether or not the property will be considered as a "capital asset," 1954 IRC § 1221 (1939 IRC § 117(a)) of the Code is applicable. This section defines "capital assets" as that "property" held by the taxpayer that is:

1. Not "stock in trade";
2. Not "included in . . . inventory";
3. Not "held primarily . . . for sale to customers";
4. Not "depreciable property used in a trade or business";
5. Not "real property used in the trade or business of the taxpayer";
6. Not "accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in 1, 2 or 3, above."

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[30] Reg. 118 § 39.23(k)-(3).

[31] I.T. 3121, 1937-2 C.B. 138; I.T. 3159, 1938-1 C.B. 188.

A mortgage is "property," but it usually is not "stock in trade" or any other of the foregoing types of property. Accordingly, under the foregoing definition, a mortgage will usually be considered as a capital asset of the mortgagee, and the mortgagee's loss or gain under the *second step* will ordinarily be a capital loss or gain.

Theory of the first step. The operation and probable theory behind these two allowable deductions can best be explained and clarified by an example. Suppose a mortgagee lends an owner $20,000 and then forecloses the mortgage with that amount due on it. The mortgagee, or another, bids only $16,000 for the property at the foreclosure sale. The owner is insolvent, so the balance of $4,000 is uncollectible. The security behind the mortgage usually consists of (1) the mortgaged property, and (2) the personal liability of the mortgagor. In the above example the mortgagee has exhausted both of these items of security and still lacks $4,000 of getting back the $20,000 he loaned to the mortgagor. The first step in making the mortgagee whole taxwise is, therefore, to allow him to deduct this $4,000 as a bad debt. The quoted Regulation allows this deduction as the *first step*.

Theory of the second step. What is the reason for the statement in the Regulation that "in addition" to the foregoing bad debt deduction the mortgagee may deduct as a loss the difference between the amount of the mortgage debt applied to the bid price and the fair market value of the mortgaged property acquired by the mortgagee? The reason appears to be that, since 1926, the Bureau has classified as an "exchange" of mortgage notes for land, a transaction wherein the mortgagee bids in the mortgaged property at foreclosure sale.[32] Therefore, in the second step, the Regulation treats as a gain or loss the difference between the value of the property and the cost to the mortgagee of the property he acquires.

Applying this theory to the above example, and assuming that the fair market value of the property acquired by the mortgagee is only $14,000, the question arises: "How much is the mortgagee's loss on this exchange?"

This deductible loss cannot be the entire difference between the $20,000 loaned by the mortgagee and the $14,000 value of the property received by the mortgagee, or $6,000, because the mortgagee has already been allowed a tax deduction of $4,000 of this $6,000 loss as a bad debt. The $4,000 bad debt deduction cuts the basis of the mortgage down to $16,000, which is the amount of the mortgagee's bid. Now the mortgagee "exchanges" this $16,000 basis of his mortgage for property worth only $14,000. It seems fair, therefore, to say that the mortgagee has sustained a loss of $2,000, and that is precisely what the *second step* of the Regulation holds. This $2,000 loss will (as mentioned above), be a capital loss if the mortgage is a capital asset of the mortgagee (which it usually is); otherwise, it will be an ordinary loss.

This last loss deduction allows the mortgagee some sort of a tax deduction for the entire amount of his loss of $6,000 (representing the difference between the $20,000 he loaned the mortgagor and the $14,000 in property he recouped from the foreclosure of his unfortunate loan). Thus, taxwise, this mortgage transaction is a closed book. The Regulation seems to be fair, at least insofar as it relates to the mortgagee's loss on foreclosure.

The basis of the property in the hands of the mortgagee is $14,000. The mortgagee must treat the property thereafter, for tax purposes, exactly as if he had paid $14,000 in cash for it.

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[32] *Nichols* v. *Commissioner* (6 Cir. 1944), 114 F. 2d 870, 32 AFTR 507.

Next, assume that the highest bidder at the foreclosure sale is a *third party* rather than the mortgagee. If a *third party* acquires the property for less than the mortgage debt, the net amount bid by him is paid to the mortgagee. If the balance of the mortgage debt is uncollectible, the mortgagee may, under the quoted Regulation, deduct this uncollectible balance as a bad debt. Insofar as the mortgagee is concerned, the mortgage transaction is then closed for tax purposes.

Mortgagee's loss of accrued, reported interest on foreclosure. Prior to foreclosure, a mortgagee who is on an accrual basis may have reported accrued interest on the mortgage as taxable income, but may have failed to collect this interest from the mortgagor. The concluding paragraph of the last-quoted Regulation provides that such previously reported interest "may be included as part of the deduction" taken by the mortgagee in determining his loss on the foreclosure. This interest is added to the cost of the mortgage which usually results in its deduction as a bad debt.

Mortgagee's attorney's fees and other expenses of compromise or foreclosure are capital expenditures. Expenses incurred or paid by the mortgagee in acquiring title to the mortgaged property, whether by compromise with the mortgagor or by foreclosure, are usually capital expenditures. They are not deductible under 1954 IRC § 162(a) (1939 IRC § 23(a)(1)(A)) as "ordinary and necessary expenses incurred in a trade or business." The 1942 "income production" amendment apparently does not broaden this rule.[33]

When the owner *compromises* with the mortgagee by voluntarily surrendering the mortgaged property to the mortgagee in exchange for cancellation of the mortgage debt, the expenses of the mortgagee in effecting the compromise must be capitalized by either (a) adding them to the cost or basis of the mortgage in the hands of the mortgagee,[34] or (b) deducting them from the value of the property acquired by the mortgagee.[35]

The result is the same in either case, i.e., the amount of the mortgagee's bad debt deduction is increased. So the effect usually is that these capital expenses are deductible in full as a bad debt.

When the mortgagee *forecloses*, the Bureau has indicated that the expenses of foreclosure may be capitalized by deducting them from the bid price, thereby increasing the mortgagee's bad debt deduction.[36]

Examples of the expenses of the mortgagee to which the foregoing rules are applicable are:

1. Attorney's fees incurred by the mortgagee in effecting a compromise with the owner, or in foreclosing the mortgage.[37]

2. Court costs, auctioneer's fees, master's fees, and all other expenses of foreclosure.[38]

3. Taxes on the mortgaged property which were a liability of the owner prior

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[33] *Lykes* v. *U.S.*, 343 U.S. 118 (1952).
[34] *Bingham* and *Spreckels*, footnote 23.
[35] *Bowles Lunch*, footnote 21.
[36] G.C.M. 19573, 1938-1 C.B. 214.
[37] *Bowles Lunch*, footnote 21; Spreckels, footnote 23.
[38] *Hadley Falls*, footnote 9.

to the foreclosure sale, or which became a lien on the mortgaged property prior to the foreclosure sale, or became either such a liability of the owner or lien prior to the acquisition of title to the mortgaged property by the mortgagee through compromise with the owner. Such taxes must be capitalized because they represent obligations of the owner which were a lien on the property and which were assumed or paid by the mortgagee for the purpose of protecting his capital investment.[39]

4. Repairs, insurance premiums, and all other expenses incurred in protecting the mortgaged property prior to the acquisition of title to the property by the mortgagee, whether by foreclosure or compromise. These items must be capitalized because the mortgagee pays them only to protect his capital investment.[40]

7. Recommendations to Mortgagees

In view of the Regulation last quoted and discussed and the unsettled state of the law with reference to gain or loss to the mortgagee on foreclosure of a mortgage, it is suggested that the following procedures be followed by the mortgagee upon foreclosure:

1. In a case where the mortgaged property is bid in by the mortgagee, an appraisal by a competent appraiser should be procured in order to be later able to establish the fair market value of the property at the time of the foreclosure. This is necessary because:
   a. Reg. 118 § 39.23(k)-(3) provides that, "The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer, in the absence of clear and convincing proof to the contrary."
   b. The mortgagee must support his gain or loss on foreclosure by proof of the fair market value of the property, because this loss or gain is the difference between the mortgagee's bid and the fair market value of the property.[41]

2. Proof that the excess of the mortgage debt over the amount bid at the foreclosure sale is "uncollectible" should be obtained and preserved. The Regulation and the provisions of the Code governing bad debt losses[42] make this worthlessness a prerequisite to the deduction of this excess as a bad debt.[43]

3. The mortgaged property should be acquired by the mortgagee with a bid as low as possible. If this is done, the mortgagee is enabled to obtain the largest possible bad debt deduction, because under Reg. 118 § 39.23(k)-(3) the mortgagee may usually deduct as a bad debt the difference between his successful bid and the amount due on his mortgage. This bad debt loss is usually deductible in full. This low bid will increase the amount of the mortgagee's capital gain resulting from the foreclosure, because the mortgagee's capital gain is measured by the excess of the fair market value of the property over the amount of the mortgagee's bid. Only one-half of this capital gain will be taxable to the mortgagee

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[39] *Hadley Falls*, footnote 9; *Hancock Life*, 10 B.T.A. 736 (acq.); *Bingham* and *Spreckels*, footnote 23; *Missouri State Life Ins. Co.* v. *Commissioner* (8 Cir. 1934), 78 F. 2d 778, 16 AFTR 473.

[40] *Hadley Falls*, footnote 9.

[41] 1954 IRC § 165(b); 1939 IRC § 23(i); Reg. 118 § 39.23(k)-(3).

[42] 1954 IRC § 166; 1939 IRC § 23(k).

[43] Reg. 118 § 39.23(k)-(3).

at a maximum rate of 25 per cent.[44] So the mortgagee will usually save taxes by bidding low and building up a large bad debt deduction, deductible in full, even though this increases his capital gain.

4. If the fair market value of the mortgaged property does not exceed the principal due on the mortgage and interest is past due and unpaid on the mortgage debt, the mortgagee should not bid in the mortgaged property for more than the principal due on the mortgage plus foreclosure costs.

If the bid of the mortgagee does not exceed the amount of principal due on the mortgage, no interest can be taxed to the mortgagee.

The mortgagee may obtain a deficiency decree against the owner for the balance due on the mortgage and, thus, the mortgagee is protected against redemption by the owner for less than the full amount of the principal and interest due on the mortgage.

On the other hand, if the mortgagee bids enough to include principal plus accrued interest, this interest may be taxed to the mortgagee as ordinary income under the doctrine of the *Midland* case, discussed above,[45] as if the interest had been paid to the mortgagee in cash.

5. If the owner surrenders the mortgaged property to the mortgagee in cancellation of the mortgage debt, the mortgagee should obtain and preserve evidence of the fair market value of the property and the worthlessness of the amount of the debt cancelled in order that the mortgagee's bad debt deduction or gain from the transaction may be supported.

8. Gain to Owner from Compromise with Mortgagee

There are several circumstances under which an owner may realize a taxable capital gain or ordinary income on cancellation of the whole or a part of the mortgage debt by a compromise with the mortgagee. We will discuss the two situations where:

1. The mortgagee reduces the mortgage debt and cancels the amount of the reduction; and
2. The mortgagee accepts the mortgaged property, which is worth less than the mortgage debt, in full satisfaction of the debt.

As a general rule, under Reg. 118 § 39.22(a)(13) (at least prior to the *American Dental* case, discussed later), the cancellation of a debt, including a mortgage debt, resulted in taxable income to the debtor. The reasons given for this rule are:

1. The net worth of the debtor is increased; and
2. Assets previously offset by obligations are freed from the claims of creditors, and thus made available to the debtor to spend as he pleases.[46] In theory, and usually *only* in theory, the cancellation of a debt furnishes the debtor with free assets just as much as a salary check does and, therefore, should be similarly taxed.

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[44] 1954 IRC § 1201; 1939 IRC § 117(c).

[45] See text at footnotes 7 through 15.

[46] *U.S.* v. *Kirby Lumber Co.*, 284 U.S. 1, 10 AFTR 458.

The general rule that a cancelled debt is taxable income to the debtor has many exceptions. We will summarize such of these exceptions as apply to the owner of mortgaged property.

No taxable income or gain is realized by the owner of mortgaged property when the mortgage debt is cancelled, in whole or in part, under the following circumstances: (The first three of these factual situations will be hereinafter discussed in more detail.)

1. The cancellation is a gift from the mortgagee to the owner.
2. The owner is insolvent before and after the mortgage debt is cancelled.
3. A purchase money mortgage is reduced or cancelled.
4. A corporate owner elects under the Code to have excluded from its income the amount of income attributable to the cancellation of its debts. Analysis of this subject would unduly prolong this discussion. The matter is fully covered in recently amended Reg. 118 § 39.113(b)(3)-1, and will not be further discussed here.
5. Reg. 118 § 39.22(a)(13) sets forth several miscellaneous exceptions which are infrequently applicable and, accordingly, are not discussed in detail here.

These exceptions are:

a. "Discharge of indebtedness of railroad corporations in certain judicial proceedings";[47]

b. "Adjudication in bankruptcy";[48]

c. Debt cancellation "by virtue of an agreement among creditors not consummated under any provision of the Bankruptcy Act, if immediately thereafter the debtor's liabilities exceed the value of his assets";

d. "Corporate reorganizations confirmed under Sec. 77-B or Chapter X of the Bankruptcy Act";

e. "Composition agreements (with creditors) confirmed under Secs. 12 or 74 of the Bankruptcy Act";

f. "An 'arrangement' or a 'real property arrangement' confirmed under Chapters XI or XII, respectively, of the Bankruptcy Act";

g. "A 'wage earner's plan' confirmed under Chapter XIII of the Bankruptcy Act."

Gratuitous cancellation of mortgage debt is usually gift, not income, to owner of mortgaged property. The most important exception to this general rule, that the cancellation of a debt, including a mortgage debt, results in taxable income to the debtor, is the *gratuitous* cancellation of the mortgage debt. Gifts have always been exempt from income tax.[49] Prior to the decision in the *American Dental* case in March, 1943,[50] the cancellation or reduction of a debt had been held to be a non-taxable gift by the creditor to the debtor only when a close personal relationship existed between them, or where other facts clearly showed a donative intent on the part of the creditor. However, the Supreme Court held in the *American Dental* case that since the creditor had received no consideration for the cancellation of part of the debt, the forgiveness amounted to a gift from creditor to debtor, regardless of the lack of donative intent on the part of the creditor, and regardless of the solvency of the debtor.

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[47] Reg. 118 § 39.22(b)(10)-1.

[48] Reg. 118 § 39.22(a)-13(b).

[49] 1954 IRC § 102 (1939 IRC § 22(b)(3)) is almost the same as the earliest income tax act on this subject, i.e., the Act of October 3, 1913, 38 Stat. 166.

[50] *Helvering* v. *American Dental Co.*, 318 U.S. 322, 30 AFTR 397 (1943).

In the *American Dental* case the debtor had previously accrued and deducted from his taxable income, but did not pay, a large amount of rent and interest which he owed. Several years later the landlord cancelled the debt for the rent in consideration of a part payment of it. The interest was forgiven without a partial payment. The Commissioner contended that both of the forgiven items constituted income to the extent that they "had served to offset income in prior years." The Supreme Court disagreed, and announced the revolutionary doctrine that because the creditor had received no consideration for the debt cancellation, the forgiveness amounted to a gift from creditor to debtor, regardless of (1) the lack of donative intent on the part of the creditor, or (2) the solvency of the debtor. The following reasoning of the Court in that case has been extensively quoted in later debt cancellation cases: (Emphasis supplied)

> Gifts is a generic word of broad connotation, taking coloration from the context of the particular statute in which it may appear. Its plain meaning in its present setting denotes, it seems to us, *the receipt of financial advantages gratuitously.*
>
> The release of interest or the complete satisfaction of an indebtedness by partial payment by the voluntary act of the creditor *is more akin to a reduction of sale price* than to financial betterment through the purchase by a debtor of its bonds in an arms-length transaction. In this view, there is no substance in the Commissioner's differentiation between a solvent or insolvent corporation or the taxation of income to the extent of assets freed from the claims of creditors by a gratuitous cancellation of indebtedness. (Citing authorities)
>
> The Board of Tax Appeals decided that these cancellations were not gifts under Sec. 22(b)(3). It was said:
>
> 'No evidence was introduced to show a donative intent upon the part of any creditor. The evidence indicates, on the contrary, that the creditors acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity.' 44 B.T.A. 425, 428.
>
> With this conclusion we cannot agree. We do not feel bound by the finding of the Board because it reached its conclusions, in our opinion, upon an application of erroneous legal standards. Sec. 22(b)(3) exempts gifts. This does not leave the Tax Court of the United States free to determine at will or upon evidence and without judicial review the tests to be applied to facts to determine whether the result is or is not a gift. *The fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the statute.*

It will be noted that part payment of the debt was held to furnish no consideration for the cancellation, obviously because the creditor was already legally entitled to receive that payment and more. It also seems significant that *there* the debtor was personally liable for the debt. So cancellation of a debt is not income to a debtor even though he is personally liable for the debt and the cancellation frees some of his assets from creditor's claims.

The rule in the *American Dental* case, that the gratuitous cancellation of a debt is a gift and not taxable income to the debtor, has been applied to the advantage of the owners of mortgaged property in several cases.[51]

The cancellation of a debt will usually be construed as a gift to the debtor unless the creditor receives something "to which he was not already entitled" in exchange for the cancellation.[52]

In the usual compromise settlement between mortgagee and owner, in which the mortgagee agrees to cancel a part or all of the mortgage debt, the mortgagee ordinarily "receives nothing to which he was not already entitled." So the amount of the mortgage debt cancelled in such settlements should usually constitute a gift and not taxable income to the owner.

The limits of the *American Dental* rule have not yet been clearly defined. The weight of authority to date appears to be sufficient to relieve the mortgage debtor from tax liability in the ordinary transaction in which the mortgage debt is reduced or cancelled. In the *Jacobson* case,[53] however, the Supreme Court refused to apply the rule of the *American Dental* case to a purchase by an individual obligor of his bonds for less than the issue price. The difference between the issue price and the lesser amount paid by him for their purchase was held to be taxable to the taxpayer. In distinguishing the *American Dental* case, the court pointed out that each transaction is a factual one, and that a gift is more likely to arise in connection with a release of an open account for rent or interest than in a sale of outstanding securities. One of the justices who joined with the majority thought that the result was essentially in conflict with that reached in the *American Dental* case. Two justices dissented.

The Tax Court held in 1943, in the case of *Elizabeth Operating Corporation*[54] that the burden of proof rests upon the debtor to show "that no consideration for the cancellation passed from the debtor to the mortgagee," and that, "It cannot be *inferred* from the mere fact that the mortgagee cancelled or reduced the debt that such action was taken gratuitously. On the contrary, it is common knowledge that creditors, as a rule, do not gratuitously forgive in whole or in part the obligations of their debtors." The Court refused to apply the *American Dental* rule in that case, and taxed the forgiven debt to the debtor because the debtor failed to affirmatively prove that the mortgagee received no consideration for the cancellation.

In view of this case, the owner of mortgaged property should always be prepared to affirmatively prove that the mortgagee received no consideration for his cancellation or reduction of the mortgage debt. Furthermore, the mortgage debtor should carefully avoid giving the mortgagee any consideration "to which the mortgagee was not already entitled."

Insolvent owner usually realizes no gain from cancellation of mortgage debt by compromise with mortgagee. Our second exception to the general rule that cancellation of a debt results in taxable income to the debtor is the situation where the owner is insolvent both before and after the cancellation of the debt.

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[51] *Liberty Mirror Works* (1944), 3 T.C. 1018; *Shellabarger* v. *Commissioner* (7 Cir. 1944), 146 F. 2d 177, 33 AFTR 351, 359; *Mendham Corp.* (1947), 9 T.C. No. 48.

[52] *Liberty Mirror Works,* footnote 51.

[53] *Commissioner* v. *Jacobson,* 336 U.S. 28, 37 AFTR 516 (1949); see also *Standard Brass,* 20 T.C. 47 (1953).

[54] *Elizabeth Operating Corp.,* 2 T.C. 1267 (1943).

When mortgaged property depreciates in value and the owner is in financial straits, the mortgagee may be willing to cancel a part or all of the mortgage debt and allow the owner to retain the property, or the mortgagee may agree to cancel the mortgage debt in full, in consideration of the owner's surrender of the mortgaged property to the mortgagee. What the owner wants to know in each such transaction, and in all other transactions in which the mortgage debt is reduced or cancelled, is whether the amount of his mortgage debt that is cancelled will be considered as taxable income or gain to him.

The theory under which a debtor is held to realize income when his debts are cancelled in whole or in part is that the debtor's net worth is increased by the cancellation, and that the cancellation frees a part of his assets from the claims of his creditors.[55] But a debtor who is insolvent both before and after the cancellation of a part of his debts, *has no net worth at all,* either before or after the cancellation, and none of his assets are freed from creditors' claims by the cancellation. Thus, when the mortgage debt is partially or wholly cancelled, an insolvent owner of mortgaged property usually realizes no taxable income or gain, even though the owner was personally liable for the mortgage debt.[56] The reason for this rule is aptly stated in a leading case on this subject as follows:

> In effect the transaction was similar to what occurs in an insolvency or bankruptcy proceeding when, upon a debtor surrendering, for the benefit of his creditors, property insufficient in value to pay his debts, he is discharged from liability for his debts. This does not result in the debtor acquiring something of exchangeable value in addition to what he had before. There is a reduction or extinguishment of liabilities without any increase of assets. There is an absence of such a gain or profit as is required to come within the accepted definition of income. (Citing cases) *Dallas Transfer Co.* v. *Commissioner* (5 Cir. 1934), 70 F. 2d 95.

Another reason for this rule is quaintly stated in *Quinn,* 31 B.T.A. 142: "A debtor has not realized income by being relieved from paying that which he in fact is unable to pay."

When the cancellation renders the debtor solvent, he realizes income to the extent that the cancellation "frees his assets from creditors' claims," *i.e.,* "to the extent the transaction renders him solvent."[57]

No taxable gain is realized when a purchase money mortgage is reduced or cancelled by compromise with the mortgagee. The third exception to the general rule that cancellation of a debt results in taxable income to the debtor is the situation where the debt reduced or cancelled is a purchase money mortgage and the value of the property retained by the owner is no greater than the amount of the mortgage debt that remains after the partial cancellation. In such a case the amount cancelled will usually not be taxable to the owner even though the owner was personally liable for the mortgage debt. The transaction is considered as a mere voluntary reduction in the cost of the property.[58]

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[55] *U.S.* v. *Kirby Lumber Co.,* 284 U.S. 1, 10 AFTR 458 (1931).

[56] *Dallas Transfer* v. *Commissioner* (5 Cir. 1934), 70 F. 2d 95, 13 AFTR 930; *Turney Estate* v. *Commissioner* (5 Cir. 1942), 126 F. 2d 712, 28 AFTR 1510; *Highland Farms Corp.,* 42 B.T.A. 1314 (1940); *Quinn,* 31 B.T.A. 142 (1934).

[57] *Texas Gas Co.* (1944), 3 T.C. 57, 61, 62; *Lakeland Grocery Co.,* 36 B.T.A. 289; *Kramon* (1944), 3 T.C. 342; *Highland Farms,* 42 B.T.A. 1314; *Cole,* 42 B.T.A. 1110.

[58] *Hirsch* v. *Commissioner* (7 Cir. 1940), 115 F. 2d 656, 25 AFTR 1038; *Ralph W. Gwinn,* par. 44,208 Prentice Hall Memorandum T.C. (1944); *Helvering* v. *Killian* (8 Cir. 1942), 128

An illustration from a leading case on this subject will best explain the reasons for this rule. In *Hirsch* v. *Commissioner*[59] the balance due on a purchase money mortgage was $15,000. The property had depreciated in value until it was worth only $8,000. The mortgagee reduced the mortgage to the value of the property, $8,000, and cancelled the balance of $7,000. The Commissioner sought to tax this $7,000 to the owner "upon the theory that a voluntary reduction of mortgage indebtedness constitutes income to the owner." The Court overruled this contention, and assigned reasons for its decision which have since been followed by almost every court that has ruled upon this subject. These reasons were:

> 1. A transaction whereby nothing of value comes to or is received by the taxpayer does not give rise to, or create, taxable income. . . . The owner received nothing of exchangeable value. He received a credit upon the cost of a capital investment. He merely entered into a transaction whereby he procured a decrease in his capital loss.
> 2. True, this was a forgiveness of indebtedness, but more than that, it was in its essence a reduction in purchase price.
> 3. The fact that after the transaction the plaintiff's balance sheet had improved was not sufficient to constitute "a gain derived from capital." If anything, it was a gain accruing to capital, and as such . . . was not taxable income.
> 4. The owner's ultimate gain or loss cannot be determined until liquidation of his capital investment. When costs go into property, whether one is to gain or lose must of necessity remain undecided until the property is sold. Credits upon the cost of the investment do not become gain until we find that what is realized upon sale exceeds the total cost, after deducting such voluntary reductions.
> 5. The reduction of the mortgage was a reduction of cost, and until the property is disposed of there is no way of knowing whether the transaction as a whole will result in gain or in loss.

In connection with this third exception attention should be paid to the sharp distinction drawn between purchase money borrowing and borrowing for other uses.[60] Other comparable situations are:

1. If the value of the mortgaged property retained by the owner exceeds the balance that remains due on the mortgage debt after the partial cancellation, then the amount of the debt that is cancelled may be taxable income to the owner to the extent that the value of the property exceeds the balance remaining due on the mortgage.[61] The reason for this rule probably is that the transaction increases the owner's net worth by the amount of such excess.

2. If the owner is not personally liable for the mortgage debt, its reduction is usually considered as merely a reduction of the cost of the property and no taxable income is realized by the owner.[62]

F. 2d 433, 29 AFTR 528; *Hextell* v. *Huston*, 28 F. Supp. 521, 23 AFTR 611, app. dism. 107 F. 2d 1016; *Gehring Publishing Co.*, 1 T.C. 345 (Acq.).

[59] *Hirsch* v. *Commissioner*, footnote 58.

[60] Compare *Chas. L. Nutter*, 7 T.C. 480 (1946) with *Lutz & Schramm*, 1 T.C. 682 (1943).

[61] *Commissioner* v. *Coastwise Transportation Co.* (1 Cir. 1934), 71 F. 2d 104, 14 AFTR 253, cert. den., 293 U.S. 595 (1934); *Coddon*, 37 B.T.A. 393 (1938); *Fifth Avenue—14th Street Corp.* v. *Commissioner* (2 Cir. 1944), 147 F. 2d 453, 33 AFTR 692.

[62] *Fulton Gold Corp.*, 31 B.T.A. 519 (1934); *American Seating Co.*, 14 B.T.A. 328 (1928), reversed on other issues (7 Cir. 1931), 50 F. 2d 681, 10 AFTR 72; *Hiatt*, 35 B.T.A. 292 (1937); *Hotel Astoria, Inc.*, 42 B.T.A. 759 (1940) (Acq.).

9. Owner's Gain on Foreclosure

Although an owner may be surprised to learn that he has sustained a taxable gain as a result of a foreclosure which deprives him of valuable property, the fact remains that under two 1947 Tax Court decisions such "gains" may result.[63]

The rule announced by the Tax Court in these two cases is that if an owner borrows money upon a mortgage on his property and uses the proceeds for his own benefit and if, later, as a result of a foreclosure of the mortgage, the mortgage debt is cancelled, the owner realizes a taxable gain to the extent that the proceeds he previously obtained from the mortgage exceed his adjusted basis for the property at the time of foreclosure.[64] The Tax Court considers this transaction as a sale of the premises to the mortgagee and not as a cancellation of indebtedness. The amount of the taxable gain is the excess of what "the owner received from the mortgagee" over the owner's basis of the property at the time of the foreclosure, and not the excess of the amount due on the mortgage over the owner's basis.[65] It seems to be a fair theory that when the owner disposes of property from which he has received a monetary enrichment (such as proceeds from a mortgage), that was not taxed or even taxable to him when received, he should take the previous enrichment into consideration in determining his gain or loss on disposition of the property and cancellation of the mortgage debt by foreclosure proceedings.

In 1952 the Second Circuit affirmed this seemingly reasonable rule and applied it to a foreclosure in which the owner was not personally liable on the mortgage.[66]

Inasmuch as the tax is not imposed upon the theory that the cancellation of the mortgage debt frees a portion of the owner's assets from creditors' claims, it would appear that the tax will be imposed regardless of the solvency of the owner, and that the *American Dental* rule, which treats a gratuitous cancellation as a gift to the debtor, will not be applicable here.

10. Owner's Loss on Surrender of Mortgaged Property to Mortgagee

If the owner decides that his mortgaged property is not worth the amount of the mortgage against it, and if he does not care to resist a foreclosure, he ordinarily surrenders the mortgaged property to the mortgagee voluntarily. In such cases the owner will not always sustain a deductible loss.[67]

The owner usually sustains a deductible loss when he surrenders mortgaged property to the mortgagee in cancellation of the mortgage debt if the owner's adjusted basis for the property is more than the amount of the mortgage debt. Any consideration received by the owner for the surrender must be considered in determining whether the owner has sustained a loss. The important question as to whether this loss will be deducted either as an ordinary or capital loss is answered in 1954 IRC § 165, 1939 IRC § 23(e) and (f), and Subtitle A, Chapter 1, Subchapter P of the 1954 Code.

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[63] See footnotes 64 and 66.

[64] *O'Dell*, 8 T.C. 1165 (1947); *Mendham Corp.*, 9 T.C. 320 (1947); *Lutz & Schramm Co.*, 1 T.C. 682 (1943).

[65] See footnote 64; 1954 IRC § 1001(a); 1939 IRC § 111(a).

[66] *Woodson Associates, Inc.* (2 Cir. 1952), 198 F. 2d 357, Aff. 16 T.C. 649.

[67] See cases at footnotes 68 through 79.

Circumstances under which mortgaged property is considered a capital asset of owner. An owner's loss on voluntary conveyance of property to the mortgagee is not considered a capital loss under Subtitle A, Chapter 1, Subchapter P of the 1954 Code, unless the mortgaged property constitutes a "capital asset" of the owner and the transfer to the mortgagee constitutes a "sale or exchange" within the meaning of the capital loss provisions of the Code.

"Capital assets" are defined by 1954 IRC § 1221, 1939 IRC § 117(a)(1). In interpreting this section, the Tax Court has held that a building is not a capital asset if it is rented, because it is then considered as being "used in a trade or business." This rule has been extended to a decision in which the Commissioner acquiesced,[68] involving a single residence converted to rental property by a lawyer who was not otherwise engaged in the "trade or business" of renting property.

Most mortgaged buildings, with the exception of homes, are usually either used in a "trade or business," or are rented. Thus, in the usual case a mortgaged building is not a capital asset and the owner's loss on such property is not a capital loss, but an ordinary loss deductible in full. The owner's losses and gains from "sales or exchanges" of such property within the taxable year must be offset against each other in the manner provided by 1954 IRC § 1231, 1939 IRC § 117(j). Any gains remaining are treated as capital gains under this section. Any losses remaining are treated as ordinary losses, deductible in full.

Certain types of mortgaged property, which would have been classified as a capital asset prior to the amendment of the Code in 1942, will not now be so classified. Accordingly, decisions respecting a mortgagee's losses, based upon the pre-1942 Code, should be read with caution. A 1954 amendment to the Code adds to the list of capital assets certain accounts and notes receivable (Sec. 1221(3)(B)(4)).

An owner's loss on his residence is usually not deductible, because it is usually neither used in a trade or business nor to produce income.[69]

When an owner is a dealer, who has held mortgaged property "primarily for sale to customers in the ordinary course of his trade or business" (such as a dealer in real estate or other mortgaged property) his loss is usually an ordinary loss deductible in full, because such property is expressly excepted from the Code definition of a capital asset.[70]

Circumstances under which surrender of mortgaged property to mortgagee is considered a "sale or exchange." A "sale or exchange" is necessary to establish a capital loss. There can be no "sale or exchange" unless the owner of the property sold receives some form of "consideration" for the transfer. Accordingly, when the owner receives no consideration whatsoever for the surrender of his mortgaged property to the mortgagee, his loss is usually not a capital loss, but is an ordinary loss deductible in full, even though the property may be a capital asset of the owner.[71]

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[68] *Hazard,* 7 T.C. 372 (1946); E. T. Roehner, "Tax Court in Error in Holding all Rental Property Is Used in Trade or Business," *Taxes,* November 1947.

[69] *Moses,* 21 B.T.A. 2261.

[70] *Black,* 45 B.T.A. 204.

It has also been held that the owner's surrender of the mortgaged property to the mortgagee without consideration is in the nature of an "abandonment" of the property by the owner, resulting in an ordinary loss.[72]

If the owner is not personally liable for the mortgage debt, the surrender of his mortgaged property to the mortgagee without consideration is usually *not* a "sale or exchange." [73]

The Courts have held, however, that where the owner receives *any* consideration (however slight) for the surrender of his mortgaged property to the mortgagee, the transaction *is* a "sale or exchange." Then, if the mortgaged property is a capital asset of the owner, the owner's loss is subject to capital loss limitations. The following considerations have been held sufficient to convert the owner's surrender of mortgaged property to the mortgagee into a "sale or exchange":

1. The owner was personally liable on the mortgage debt. This liability was extinguished as a consideration for the surrender of the mortgaged property to the mortgagee.[74] Such a discharge of personal liability may be implied from the recitals of the deed.[75] However, no consideration for the surrender was found to exist where the owner *was originally* personally liable on the mortgage debt, but this liability was extinguished by an agreement between the owner and mortgagee entered into three years prior to the owner's surrender of the mortgaged property to the mortgagee.[76]
2. Taxes on the mortgaged property, for which the owner was personally liable, were unpaid at the time of the surrender of the property. The mortgagee assumed liability for these taxes in accepting the deed.[77] In one case, where the amount of such accrued taxes was small, they were ignored.[78]
3. The mortgagee paid the owner's attorney a fee of $250 for obtaining the deed from the owner.[79]

Accordingly, if the mortgaged property is a capital asset of the owner, all such considerations for the conveyance of the mortgaged property to the mortgagee should be avoided, unless the benefits to be derived from these considerations outweigh their tax disadvantages.

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[71] *Stokes* v. *Commissioner* (3 Cir. 1941), 124 F. 2d 335, 28 AFTR 656; *Polin* v. *Commissioner* (3 Cir. 1940), 114 F. 2d 174, 25 AFTR 598.

[72] In *Commonwealth, Inc.*, 36 B.T.A. 850 (1937), the Court reasoned on this subject as follows: "Inasmuch as there was in fact no consideration to the owner, the transfer of title was not a sale or exchange. *The execution of the deed marked the close of a transaction whereby the mortgagor abandoned its title.*"

[73] *Polin* v. *Commissioner* (3 Cir. 1940), 114 F. 2d 174, 25 AFTR 598; *Jamison*, 8 T.C. 173 (1947). But see also cases at footnotes 63 through 66.

[74] *Rogers* v. *Commissioner* (9 Cir. 1939), 103 F. 2d 790, 22 AFTR 1129, cert. den. 308 U.S. 580; *Pender* v. *Commissioner*, 110 F. 2d 477, cert. den. 310 U.S. 650.

[75] *Stamler* v. *Commissioner* (3 Cir. 1944), 145 F. 2d 37, 32 AFTR 1440.

[76] *Burnquist*, 44 B.T.A. 484 (non-acq.), app. dism. 123 F. 2d 64.

[77] *Phillips* v. *Commissioner* (3 Cir. 1940), 112 F. 2d 721, 25 AFTR 274; *Aberle* v. *Commissioner*, 121 F. 2d 726, 27 AFTR 738.

[78] *Stokes*, footnote 71.

[79] *Blum* v. *Commissioner* (2 Cir. 1943), 133 F. 2d 447, 30 AFTR 929.

11. Owner's Loss on Abandonment of Mortgaged Property

When an owner finds that his mortgaged property is not worth the amount of the mortgage he sometimes simply abandons it, instead of surrendering it to the mortgagee. In such cases there is no "sale or exchange" of the mortgaged property. So the owner's loss is usually deductible in full as an ordinary loss.[80] The rules applicable to an owner's loss on abandonment are the same as in the case of a voluntary surrender of the mortgaged property to the mortgagee without consideration.

The following cases suffice to show the difficulty of establishing an abandonment loss.

One case holds that the loss should be allowed in the year that the owner refused to pay interest and taxes and permitted a receiver to be appointed for the property, when the owner's equity was worthless.[81] Another case holds, under almost the same facts, that no loss is allowable until foreclosure sale, because the owner's equity may have some value until then.[82] Another case holds that the loss is not allowable on abandonment if there is a continuing personal liability of the owner on the mortgage debt, but must await foreclosure sale, because of the possibility of a deficiency judgment.[83]

In cases where the owner's loss on abandonment is not complete until foreclosure sale, the loss is usually held to be a capital loss and not an ordinary loss.[84]

It appears preferable for the owner to avoid any danger as to whether and when his loss will be deductible, and whether it will be an ordinary or capital loss, by surrendering the mortgaged property to the mortgagee without consideration, rather than by abandoning it. The law concerning the owner's loss on surrender of the mortgaged property to the mortgagee is far more clear and settled than the law on abandonment.[85]

12. Owner's Loss on Foreclosure

In 1941 the United States Supreme Court held, in the *Hammel* case,[86] that a foreclosure sale is a "sale" within the meaning of the capital gain and loss provisions of the Code, regardless of whether the owner is personally liable for the mortgage debt. This means that an owner's loss on foreclosure will always be a capital loss *if* the mortgaged property is a capital asset. However, the lower court decisions which hold that rented buildings are not capital assets[87] will prevent much mortgaged property (except homes) from being classified as a capital asset. Thus, the end result is that an owner's loss on the usual mortgage foreclosure will not be a capital loss, but will be deductible in full as an ordinary loss.

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[80] *Rhodes* v. *Commissioner* (6 Cir. 1939), 100 F. 2d 966, 22 AFTR 366.

[81] *Commissioner* v. *Hoffman* (2 Cir. 1941), 117 F. 2d 987, 26 AFTR 486.

[82] *Commissioner* v. *Abramson* (2 Cir. 1942), 124 F. 2d 416, 28 AFTR 779.

[83] *Commissioner* v. *Green* (3 Cir. 1942), 126 F. 2d 70, 28 AFTR 1286.

[84] See footnotes 82 and 83.

[85] *Kahn,* 44 B.T.A. 84 (1941); *Realty Operators, Inc.,* 40 B.T.A. 1051 (1942), app. dism. 118 F. 2d 286.

[86] *Commissioner* v. *Hammel,* 311 U.S. 504, 24 AFTR 1082 (1941).

[87] See footnote 68.

In any event, if the mortgaged property is a capital asset, the owner's loss on foreclosure will be a capital loss. If the mortgaged property is not a capital asset, the owner's loss will usually be an ordinary loss, deductible in full.[88]

Amount of owner's loss on surrender or abandonment of mortgaged property or on foreclosure. The amount of the owner's loss on abandonment of mortgaged property or on foreclosure is computed as in any other "sale" if the property is a capital asset. 1954 IRC Sec. 1001 (1939 IRC Sec. 111(a)) provides that the amount of loss from the sale of the property shall be the excess of the adjusted basis (provided in 1954 IRC § 1011, 1939 IRC § 113(b) for determining loss) over the amount realized by the seller. The "amount realized" by the seller is defined as "the sum of any money received plus the fair market value of the property (other than money) received."[89] The "amount realized" by the owner on foreclosure would seem to be the amount of the mortgage debt, unless the bid exceeds the mortgage debt. In that event the "amount realized" by the owner would be the bid price.

In 1947 the United States Supreme Court held in the *Crane* case[90] that when mortgaged property is sold "the amount of the mortgage is properly included in (determining) the 'amount realized,'" regardless of whether or not the seller is personally liable for the mortgage debt.

If the amount bid at the foreclosure sale is sufficient to include accrued interest on the mortgage debt a cash basis owner may deduct this interest as having been paid even though it has not been paid in cash.[91]

Any amount paid by the owner to settle a deficiency judgment obtained in a foreclosure suit may be included as a part of the owner's loss on foreclosure.[92]

The owner's loss on foreclosure is deductible in the year in which the owner's right to redeem the mortgaged property from the foreclosure sale expires under state law.[93] When no right of redemption exists, the date of the foreclosure sale, rather than the date of the final decree, fixes the date of the owner's loss.[94]

13. Recommendations to Owners of Mortgaged Property in Handling Compromises and Foreclosures

The following suggestions may help an owner to avoid unnecessary income taxes in foreclosure and in compromises with the mortgagee:

1. The owner should, when practicable, avoid receiving any consideration whatsoever from the mortgagee upon surrendering mortgaged property to the

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[88] *Commissioner* v. *Hammel*, 311 U.S. 504, 24 AFTR 1082 (1941); *Electro-Chemical Engraving Co.* v. *Commissioner*, 311 U.S. 513 (1941).

[89] 1954 IRC § 1001(b); 1939 IRC § 111(b).

[90] *Crane* v. *Commissioner*, 331 U.S. 1, 35 AFTR 776 (1947).

[91] *Blossom*, 38 B.T.A. 1136 (1938); *Helvering* v. *Midland Life Insurance*, 300 U.S. 216, 18 AFTR 1144 (1937).

[92] *Diamond*, 43 B.T.A. 809 (1941); *Hawkins*, 34 B.T.A. 918, aff. (5 Cir. 1937), 91 F. 2d 354, 19 AFTR 1116 (1937).

[93] G.C.M. 19367, 1937-2 C.B., 115; *Hawkins*, 34 B.T.A. 918, aff. (5 Cir. 1937), 91 F. 2d 354, 19 AFTR 1116.

[94] *Commissioner* v. *Hammel*, 311 U.S. 504, 24 AFTR 1082 (1941).

mortgagee in cancellation of the mortgage debt, if the receipt of such consideration will result in converting an ordinary loss into a capital loss, and the additional tax to the owner occasioned thereby will exceed the consideration received by the owner. The reasons for this suggestion are that:

(a) If the owner surrenders mortgaged property to the mortgagee in cancellation of the mortgage debt and the owner receives no consideration for the surrender, the owner's loss is usually an ordinary loss, deductible in full.[95]

(b) If the owner surrenders mortgaged property to the mortgagee that is a capital asset of the owner and receives a consideration of some kind for the surrender, his loss will usually be a capital loss subject to the limitations on deductibility applicable to such losses. The reason is that the "consideration" converts the transaction into a "sale or exchange" of a capital asset.

(c) Sometimes the consideration is slight. In one case it amounted to only $250, which was retained by the owner's attorney, yet that small amount of consideration prevented the owner from deducting $32,000 as an ordinary loss.[96] Under present tax rates such a mistake might prove to be very expensive to the owner.

2. The release of the owner's personal liability on a mortgage debt will usually amount to such "consideration" as will convert an ordinary loss into a capital loss, when given at the same time and as consideration for the owner's surrender of mortgaged property to the mortgagee. If so, then do not take the release at that time. Take the release prior to the surrender of the property to the mortgagee and support it by a separate consideration. The reasons for this suggestion are that:

(a) It has been held that where the owner's personal liability on the mortgage debt was released by an agreement between the owner and the mortgagee, entered into sufficiently prior to the conveyance of the mortgaged property from the owner to the mortgagee so that the release of liability and the conveyance of the property were not considered as a part of the same transaction, then there was no consideration for the conveyance and the owner's loss on the surrender of his property to the mortgagee was an ordinary loss deductible in full. In that particular case, the prior release saved the owner taxes on approximately $15,000.[97]

(b) If the owner surrenders mortgaged property to the mortgagee, however, as consideration for the cancellation of the owner's personal liability for the mortgage debt, and if the property is a capital asset of the owner, the owner's loss is usually a capital loss. The reason for this rule is that the cancellation of the owner's personal liability in exchange for a deed to the property is held sufficient consideration to the owner to convert the transaction into a "sale or exchange."

3. 1954 IRC Sec. 267 (1939 IRC Sec. 24 (b)(1)) provides that "No deduction shall be allowed in respect of losses from sales or exchanges of property . . . directly or indirectly between persons specified within any one of the paragraphs of subsection (b)." Subsection (b) lists, among others, the following:

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[95] See text at footnotes 71 to 79.

[96] *Blum* v. *Commissioner* (2 Cir. 1943), 133 F. 2d 447, 30 AFTR 929.

[97] *Burnquist,* 44 B.T.A. 484 (non-acq.), app. dism. (8 Cir. 1941), 123 F. 2d 64.

Members of a family; an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual.

Applying this section, the Tax Court *disallowed* a loss resulting to an owner from a conveyance of mortgaged property to his brother in consideration for being relieved from making payments on the mortgage.[98] In 1947 the Tax Court also applied this section to a foreclosure sale, and disallowed the owner's loss, on the sole ground that the property was bid in by members of the owner's family.[99] It would seem that losses to *mortgagees* may also be disallowed under this section. So if it appears that, under this section, a loss to a mortgagor or mortgagee upon voluntary surrender of mortgaged property to a mortgagee, or upon foreclosure, will be disallowed, the owner should sell the property, or the mortgagee should sell the mortgage, to a third party not embraced within this section prior to the surrender or foreclosure. In no event should mortgaged property be bid in on foreclosure sale by, or surrendered to, a person or corporation embraced within this section, whether mortgagee or not, if the foreclosure or conveyance would otherwise have resulted in a deductible loss to either party.

4. If it appears that the foreclosure of a mortgage will result in only a capital loss to the owner of the mortgaged property (for example, where the mortgaged property is a capital asset of the owner), it will usually be advisable for the owner to avoid foreclosure by voluntarily surrendering the property to the mortgagee without consideration. This will usually convert the capital loss into an ordinary loss, deductible in full. For example: Where the owner is not personally liable for the mortgage debt, a surrender of the mortgaged property to the mortgagee without consideration will not be a "sale or exchange" and the owner's loss will usually be deductible in full.[100]

5. By quitclaiming the property to the mortgagee after foreclosure, the owner may accelerate the year of loss to a year in which he will realize the greatest tax benefit from the loss deduction. The reasons for this suggestion are:

> (a) An owner's loss on foreclosure is deductible in the year in which his right to redeem the property from the foreclosure sale expires.[101]
>
> (b) If the owner quitclaims the property to the mortgagee after foreclosure sale, however, the owner may deduct his loss on the foreclosure in the year in which he delivers this quitclaim deed to the mortgagee.[102]

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[98] *Stamler,* 45 B.T.A. 37.

[99] *Zacek,* 8 T.C. 1056.

[100] See text at footnote 73.

[101] See footnotes 93 and 94.

[102] *Hill,* 40 B.T.A. 376 (non-acq.), reversed on other grounds, (6 Cir. 1941), 119 F. 2d 421.

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Causes and Effects of a Negative Basis in Mortgage Transactions

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The disasters awaiting the unwary mortgagor have been charted in the preceding chapter, along with the suggested courses for avoiding the hazards. You have been warned that a voluntary conveyance of mortgaged property to the mortgagee can give you an ordinary loss if you receive no "boot," though your property is a capital asset, but that even the most nominal consideration will limit you to capital loss. If you are personally liable on the mortgage and get your personal discharge as an incident of the voluntary conveyance to the mortgagee, you have received the requisite consideration for a capital loss, but an ordinary loss is yours if your personal liability is extinguished prior to the conveyance. You have been told, moreover, that foreclosure of a capital asset will in every instance produce capital loss, though abandonment can give you ordinary loss.

You have seen that the owner who is personally liable on mortgaged property may be treated differently from the unindebted owner. Most surprisingly, perhaps, you have been told you might lose your investment in property by foreclosure and yet wind up owing tax on a gain!

At the root of these almost mystical rules, that seem derived more from supernatural than natural law, is a negative equity, and in the last-cited instance of taxable gain, a negative basis too.

1. Points to Consider

In your dealings with mortgaged property, you must be able to spot the negative equity and appreciate its special significance, and take care not to confuse it with a negative basis. You must recognize the situations giving rise to a negative basis, and anticipate the tax consequences flowing therefrom, such as the gain to be realized on disposition even after the owner's equity becomes negative; and you should explore the means of avoiding such consequences. You will also want to know the special problems for corporations having property with negative bases that the new Revenue Act has created. These, then, are points you will want to consider:

	Section
Distinction between negative basis and negative equity	2
Mortgage transactions producing negative bases	3
Depreciation before and after a negative basis	4, 5
Tax result on disposing of mortgaged property with negative basis	6, 7
Complications added by negative equity	8
Risk of accelerating tax to time mortgage is placed	9
Exposure of corporations distributing "windfalls"	10
Chances of defeating tax for all time	11

2. Negative Basis and Negative Equity Contrasted

The term "negative equity" describes the case where the mortgage exceeds the value of the property, so that there is an absence of any value to the owner's equity, viz., property value 7, mortgage 10. It is in such cases that the owner must think of disposing of his property, generally to the mortgagee in discharge, or partial discharge, of the debt, sometimes via foreclosure proceedings, occasionally by abandonment, and even more rarely by sale to a speculator or other operator who is willing to take a "flier" in a piece of property encumbered to the hilt.

Negative equities have figured in tax cases such as the foregoing for many years, producing the disparate rules set forth at the outset of this chapter. While the overly technical character of these rules may have offended the student, the fact that they were, as we shall see, erroneously premised on a formulation of the issues in terms of debt discharge, probably went unsuspected until the appearance of tax cases involving negative bases. Here judges found it very difficult under the rigid "debt discharge" test to find a realization of the gain. Their consciences told them this gain must be taxed when a taxpayer on the termination of his relation with the subject property has a tax basis that is lower than the amount of the mortgage on the property. This situation signifies a benefit to the owner to the extent of the excess of mortgage over basis.

Strictly speaking, a negative basis is a tax basis of less than zero; but to date this has never been found by any court to exist, and, indeed, the Supreme Court has found it abhorrent.[1] In the context of mortgage cases the term "negative basis" has come to be used when the outstanding mortgage debt exceeds the basis of the property, viz, basis 6, mortgage 10. In the normal situation the owner has a positive equity in the property with a negative basis, so that where the basis is 6 and the mortgage is 10, the value of the property might be 12 or 15. However, where there is an absence of equity, the value of the property is less than the mortgage, say 9 or less, and that value may or may not be greater than the basis. Regardless of the relation of basis and value, so long as they are both below the amount of the mortgage, the property account will show both a negative basis and a negative equity.

3. Derivations of Negative Bases

It is obvious enough how the owner of mortgaged property comes by a negative equity: physical depreciation or the fluctuations of the real estate market run ahead of the owner's expectations, and he is left with property worth less than the encumbrances against it. His tax basis may still be on his books at a figure in excess of the mortgage, thus showing a book equity; but the concept of negative equity is not concerned with tax basis or even book value.

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[1] See *Crane* v. *Comm'r,* 331 U.S. 1, 10 (1947); but cf. Magruder, J., concurring in *Parker* v. *Delaney,* 186 F. 2d 445 (1 Cir. 1950).

At least until the much publicized hearings before the Senate Banking Committee into post-war building with government-insured loans, at the Second Session of the Eighty-Third Congress, the ways in which a negative basis can come about were less well known. Long before these hearings, the initiate knew that if you bought land and built at a cost of $800,000 what the FHA would guarantee loans against of up to $1,000,000, you had a neat "windfall." You also had a negative basis, for in "mortgaging out" you encumbered the property for more than its cost, or basis.

Negative bases were also happening in less spectacular ways even before the building boom. The leading *Crane* case[2] has told us that where a mortgage is reflected in the purchase price of property, as where the buyer gives a purchase money mortgage, or assumes an existing one, or even simply takes subject to one, the mortgage is counted in the tax basis of the property, so that a purchase price of $3 cash and $10 in mortgages produces a basis of $13. The basis may become negative in several ways. Thus, if the taxpayer deducts more depreciation than his cash investment, he has a negative basis; viz.:

Original cash	3
Mortgages	10
Basis	13
Less depreciation	7
Adjusted basis	6

The negative basis may also occur in an inflated real estate market when the owner obtains a mortgage on his property, some time after he acquires it, for an amount in excess of his original cost (or, at least, his adjusted cost after depreciation).[3] This would be the case where property is originally bought for $300,000 all cash, or cash and mortgages, and subsequently a new mortgage is raised for $350,000.

4. Basis for Depreciation

As already noted, in the *Crane* opinion the Supreme Court expressly rejected an equity basis for depreciation of mortgaged property, and approved depreciation deductions computed upon a basis which includes not only the taxpayer's cash investment in the property, but also the amount of any mortgages reflected in the cost of the property. The Court reasoned that to make depreciation deductions wait upon amortization of the mortgage would require repeated recomputations of basis and of annual allowances with each payment on the mortgage, and, more seriously, would sharply curtail the amount of depreciation allowances in relation to the physical exhaustion of the property. More precisely, of course, the distortion of the depreciation account would be manifested by understatement in the earlier and presumably bigger income years of the property and exaggeration in the declining income years of the property.[4]

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[2] See footnote 1.

[3] See *Woodsam Associates, Inc.* v. *Comm'r*, 198 F. 2d 357 (2 Cir. 1952), aff'g 16 T.C. 649.

Where a lien reflected in the cost of the property, and consequently includible in the basis, is subsequently retired at a discount, it has been held that the depreciation basis need not be reduced, retroactive to the acquisition of the property, for years prior to the retirement of the lien.[5] The taxpayer had purchased property encumbered by heavy tax liens and took depreciation deductions on a basis which included the full amount of these liens. In a later year it purchased these liens at a discount. The Tax Court refused to require the taxpayer to recompute its depreciation on a lower basis for years prior to the purchase of the liens; but the Court expressly left open the question of the effect of the purchase of the liens on subsequent years' depreciation. In this the Court was unduly coy; for it would seem to take no more than an application of the "reduction of cost" theory, discussed in the preceding chapter, to view the lien discounts as reductions of purchase price, resulting in reduction of basis by the amount so reduced.[6]

In the case just discussed, the property owner bought the liens. The problem is different where the lienholder buys the property, but with the lien not merging in the fee. Where the holder of a second mortgage acquired the encumbered property for an additional consideration over the mortgages, thus indicating a positive equity, it has been held that the *Crane* rule of basis requires inclusion in the basis of the second mortgage, notwithstanding that the buyer is the obligee under the mortgage.[7] It is perfectly clear that the amount of the second mortgage was an element of the purchase price, affecting the cash consideration paid over the mortgages, and so seems to have a place in the computation of the buyer's cost basis.

The Tax Court's reasoning that the buyer assumed the mortgage, even though it was owing to himself, is a little too mechanical to be convincing; but perhaps this is an acceptable legal short-hand statement of the fact that the mortgagee, by accepting the property without merging the mortgage has agreed that the property shall become the primary fund for the payment of the mortgage debt even though the personal claim against the mortgagor is not surrendered. In other words, while the mortgagee does not assume the obligation to pay himself the debt, property of which the mortgagee is the owner does assume the debt (if we may so personify the land).

The effect is that the mortgagee has given up his personal claim against the mortgagor as consideration for the property, though only to the extent that the mortgage debt can be satisfied out of the property; and this appears to be the real reason why it is proper to include the amount of the mortgage in the basis. As events stand at the purchase date, the property is good for 100 per cent of the debt, so this figure seems an appropriate one for inclusion in basis.[8]

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[4] The author of a Comment in 26 *Tex. L. Rev.* 796 (1948) gives the example of a building, with an estimated life of 50 years, bought by the taxpayer for $20,000 cash, subject to a mortgage of $60,000, which the taxpayer is to amortize at the rate of $1,500 per year for 40 years. If the down-payment and each subsequent payment were amortized over the remaining life of the building from the date of each payment, the schedule of depreciation allowances would be as follows: 1st year—$400.00; 2d year—$430.60; 3d year—$461.85; .... 41st-50th yrs.—$2,880.00 (each year). Thus the allowance for the last years is more than seven times that for the first year.

[5] *Blackstone Theatre Co.*, 12 T.C. 801 (1949).

[6] See *Hirsch* v. *Comm'r*, 115 F. 2d 656 (7 Cir. 1940); *Fulton Gold Corp.*, 31 B.T.A. 519 (1934); *P. J. Hiatt*, 35 B.T.A. 292 (1936); *Hotel Astoria, Inc.*, 42 B.T.A. 759 (1940); cf. *Comm'r* v. *Jacobson*, 336 U.S. 28 (1949); *Charles Nutter*, 7 T.C. 480 (1946).

[7] *Walter F. Sheehan*, T.C. Memo. P-H, par. 50,138, C.C.H. Dec. 17, 684 (M).

However, if at the time the mortgagee accepts a conveyance of the mortgaged property, without allowing the mortgage to merge, the value of the property is not worth the amount of the mortgage, the Second Circuit has held that the mortgagee may not include in his cost basis the amount of the mortgage owed to him; but basis is then rather limited to the market value of the property.[9] In this case the mortgagee urged that, because his mortgage did not merge in the fee he acquired, and thus he still had his personal claim against the mortgagor, he consequently could not then claim a bad debt deduction, and so he should be permitted to preserve the full amount of the mortgage in his cost basis. The court recognized, however, that the debt transaction and the property acquisition were separate, and that a bad debt deduction might well be taken at a subsequent time, without having to affect basis.

The decision of the Second Circuit seems inarguable. It is proper to include in a buyer's basis for property the full amount of his own surviving encumbrance against the property where the property is worth more than the encumbrance, only because the amount of personal claim which the mortgagee will give up in consideration for the property will presumably equal the full mortgage debt, barring a sharp break in the value of the property. By the same token, it is not proper to give the mortgagee credit in his basis for the full amount of his own surviving encumbrance where the property is worth less than the encumbrance; because, as events stand then, he will only be relinquishing his personal claim against the mortgagor for an amount less than the full mortgage, to wit, fair market value.

It should be recognized in all cases where the mortgagee acquires the mortgaged property impressed with the lien of his own surviving mortgage—irrespective of whether the property has a value over the mortgage—that the mortgagee's cost basis for the property is necessarily tentative, being based on the value of the property at the immediate date of acquisition by the mortgagee; whereas the critical date in determining the mortgagee's cost basis for the property is the date the property is applied against the debt, since the extent to which his cost basis can include the amount of the lien would seem to depend upon the amount of the lien debt satisfied out of the property without recourse to the lienor's personal liability.[10] The tentative cost basis should be sufficient, however, for depreciation

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[8] This figure, however is only a tentative one. See footnote 10.

[9] *Kohn* v. *Comm'r*, 197 F. 2d 480 (2 Cir. 1952), affg 16 T.C. 960.

[10] In cases such as the *Sheehan* case, footnote 7 above—where the property value exceeds the mortgage when the mortgagee acquires it, but subsequently declines and is sold to satisfy the mortgage debt, *pro tanto*, and the mortgagee recovers the deficiency from the mortgagor—the mortgagee will have gotten an excessive loss deduction unless his basis is corrected by the amount of the mortgage not satisfied out of the property.

In cases like *Kohn*, footnote 9 above—where, because of the property value being less than the mortgage when the mortgagee acquires it, his basis has been limited to its then value, but the property subsequently appreciates so that it is worth the amount of the mortgage, or more—the basis should be increased up to the amount of the lien for purposes of computing gain on a disposition of the property, because the "amount realized" will include the sum of the mortgage (see discussion following at section 6) and the mortgagee would thus be charged with a gain that he has not purposes; because it corresponds with probabilities, giving the owner a base that accords as nearly as can be determined in advance with his ultimate investment in the property.

5. Depreciation After Negative Basis

Calling for a depreciation base that will in every instance be governed by the probabilities of the owner's cash investment, some commentators have criticized the operation of the *Crane* basis rule where the owner's basis is at the threshold of becoming negative. Use of a depreciation basis including not only the buyer's cash investment, but also the encumbrances against the property, obviously makes for the possibility that the aggregate of depreciation deductions may at some point exceed the total cash investment; and, in fact, far and away the most common manner of achieving a negative basis (at least before the era of "windfalls") was through the taking of depreciation deductions in an amount in excess of the cash outlay.[11] No court has said in so many words that a property owner may continue to claim depreciation even after he has recovered his cash, but the Supreme Court in the *Crane* case gave its tacit approval of this practice.

Some critics, offended by the possibilities inherent in the parlaying of a cash investment of only a small fraction of the total cost of the property into an annual depreciation deduction which each year rivals the original cash, have urged that depreciation deductions be suspended when the aggregate cash investment has been fully recovered through depreciation allowances, to be resumed only on additional amortization of the mortgage.[12] Others would allow depreciation in excess of the taxpayer's cash investment so long as the actual value of the property exceeds the mortgage, making the touchstone of the deduction the probability of the taxpayer's paying off the mortgage.[13]

It is probably safe to assume that the Supreme Court will continue to allow depreciation on a negative basis—certainly as long as the property continues to have a value above the mortgage.[14]

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realized if the adjustment is not made. Conversely, a further decline in the value of the property after its acquisition by the mortgagee or an appreciation which still leaves the property worth less than the mortgage, should result, in the event of foreclosure, in an adjustment to make the mortgagee's basis correspond to the property value at the time of foreclosure; because any loss will be recovered through a bad debt deduction.

[11] E.g., see *Crane* v. *Comm'r*, 331 U.S. 1 (1947); *Parker* v. *Delaney*, 186 F. 2d 455 (1 Cir. 1950); *Lutz & Schramm Co.*, 1 T.C. 682 (1943); *O'Dell & Sons Co.*, 8 T.C. 1165 (1947), aff'd 169 F. 2d 247 (3 Cir. 1948); *Mendham Corp.*, 9 T.C. 320 (1947).

[12] E.g., Comment, 26 *Tex. L. Rev*. 796 (1948); Note, 21 *So. Calif. L. Rev*. 112 (1947); cf. Note, 13 *U. of Chi. L. Rev*. 510 (1946). Observe, however, that this excessive depreciation will be taxed (though only at capital gain rates, if the property is a capital asset) on the disposition of the property. See discussion following section 6. The author of the Comment in 26 *Tex. L. Rev*., *supra*, has suggested an ingenious formula for cutting off depreciation deductions when the aggregate cash investment has been fully recovered through depreciation, and for resuming the deductions upon additional mortgage payments, while at the same time avoiding the distortions of the formula outlined in footnote 4 above.

[13] Note, 49 *Col. L. Rev*. 845 (1949). The notewriter in 13 *U. of Chi. L. Rev*., footnote 12, above, expresses sympathy with this approach, but rejects it because of the complications for the taxpayer and the Government if the depreciation deduction is made dependent upon the actual value of the property at any given time.

[14] The *Crane* opinion itself indicates doubt as to whether a depreciation deduction is sustainable by an unindebted mortgagor where the property is clearly worth less than the lien. 331 U.S. 1, 12

6. Gain on Taxable Dispositions

When you come to dispose of property in respect of which the basis is lower than the mortgage, the cases have taught us that this will be the occasion for a taxable gain. The applicable section of the new Code here is Section 1001 (Section 111 under the 1939 Code), which in the determination of gain or loss on the sale or other disposition of property requires a comparison of that which is embraced by the concept "amount realized" with that which is included in the concept of "basis."

The courts have had no difficulty finding the requisite "amount realized" in the assumption of a mortgage by one who buys encumbered property from an owner who is himself personally liable for the mortgage.[15] The full amount of the mortgage is counted in the consideration received, and if that amount, together with any actual cash passing from buyer to seller, is less than the basis, there is loss; but if this amount alone or together with any actual cash is more than the basis, there is gain.

The full amount of the mortgage is also included in the "amount realized" where the buyer merely takes subject to, without assuming, the seller's mortgage;[16] but here the analysts have had difficulty in rationalizing the result because the counting of the mortgage in the "amount realized" has been thought to depend upon the seller's receiving from the buyer something in the nature of debt discharge, or at least debt assumption which is its equivalent.[17] In truth, there is no less reason for charging the owner with income where the buyer does not assume the mortgage debt, because the only extra benefit that would accrue to him if his buyer did assume would be the substitution of a secondary for a primary personal liability in the contingency of a deficiency judgment.

Even if the transfer of mortgaged property to a buyer who assumes the debt had the effect of cutting off all further liability of the transferor for any deficiency, this benefit would be at most a contingent one, to be availed of only if the property were to decline in value below the amount of the mortgage at a later date and be foreclosed. But the fact is that apart from the rare instances of a novation, the personal liability of the seller to the mortgagee remains intact whether or not the buyer assumes the mortgage, except that: (1) the property in the buyer's hands becomes the principal fund for the payment of the mortgage debt, so the personal liability of the seller becomes a surety liability; and (2) in addition, where the buyer assumes the debt, the seller's personal liability as surety is remitted from a primary to secondary position.[18] Thus, the only "extra" for a seller whose buyer assumes lies in the change from a primary to a secondary

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(1947). To the contrary, one writer has criticized any limitation on the depreciation deduction, even because of the mortgage exceeding the value of the property. Braunfeld, "Subject to a Mortgage I," 25 *Taxes* 155, 156 (1947).

[15] See *Brons Hotel, Inc.*, 34 B.T.A. 376 (1936); *Walter Haass*, 37 B.T.A. 948 (1938).

[16] See Reg. 118 § 39.113(a)(6)-2(b), Example (2).

[17] See Braunfeld, "Subject to a Mortgage I," 24 *Taxes* 424 (1946); Note, 60, *Harv. L. Rev.* 1324 (1947).

[18] See Storke and Sears, "Transfer of Mortgaged Property," 38 *Cornell L.Q.* 185, 192-194 (1953).

surety liability for a deficiency which will itself only become owing in the eventuality of a deficiency judgment. This would hardly appear to be a sufficient benefit to warrant a different tax result in cases where buyers assume the mortgage, on the one hand, and those where they do not, on the other.

More fundamentally, it is actually erroneous to try to explain the counting of the mortgage in the "amount realized" in terms of a personal benefit in the nature of release from debt. This was brought home forcefully to the Supreme Court in the *Crane* case, where the seller was not personally liable for the mortgage, and so it was well nigh impossible to rationalize the result in terms of debt discharge. Yet, the Court felt instinctively that the benefit is as real to the unindebted mortgagor as to the indebted mortgagor, because, in the words of the opinion, "an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations." So the Court charged the seller with the full amount of the mortgage.

Mrs. Crane had inherited a piece of property worth approximately $250,000, which was then encumbered by a mortgage exactly equal to its value. She proceeded to operate the property under an arrangement with the mortgagee, whereby she collected the rents, paid the taxes and the expenses of repairs and maintenance, and turned the net rentals over to the mortgagee to be applied against interest charges. After several years, and with foreclosure imminent, she succeeded in interesting a buyer in the property, and sold it to him for $3,000 cash. The buyer took subject to the mortgage but did not assume it (exactly as she had herself done). During the period of her ownership, she had been allowed depreciation deductions aggregating approximately $25,000.

In rounded figures, Mrs. Crane reported a profit of $3,000 (actually only $1,500, as long-term capital gain). The Commissioner, however, claimed that her profit was $28,000, arguing that she realized not only the amount of the "boot," but also the full amount of the mortgage (which still equalled $250,000), or a total "amount realized" of $253,000, and this had to be compared with an adjusted basis of $225,000 (arrived at by subtracting the depreciation from the original basis of $250,000).

It is submitted that the Court properly found a taxable gain in the *Crane* case, but that it fastened on the wrong element in reaching this result. The sale of mortgaged property has two distinct elements, the disposition of the property and the discharge from or assumption of the mortgage debt. Each of these may have its own separate tax consequences. The property disposition produces gain (or loss), as on any sale or exchange, depending upon the relation of the "amount realized" to the basis. The debt payment, or debt assumption which is its equivalent, normally has no tax consequences (unless the debt is assumed or discharged at a discount, in which event ordinary income from the gratuitous cancellation of indebtedness may be realized).

The two elements are necessarily interrelated and easily confused, because the discharge from, or assumption of, the mortgage, accrues to the owner as consideration for the disposition of the property. Thus, because the consideration takes the form of debt discharge or debt assumption to the extent of the mortgage, it is almost irresistible to characterize the taxpayer's realization of income as stemming from debt assumption or discharge, as the court seems to have done in the *Crane* case. This made it necessary for the court to find debt assumption, which created difficulty because of the taxpayer's lack of personal liability for the mortgage.

In other words, the Court appears to have been trapped into looking for an equivalent of debt assumption in order to support a tax, when, in fact, a buyer's assumption of the mortgage is not what gives rise to tax. There are principally two arguments which have been made to show the dependence of the tax on debt assumption. The more naive of these is that taxable income can arise only on a release from liability, and that where the owner is not liable for the mortgage debt, the disposition of his property cannot effect for him a release from liability. This argument simply confuses the concept of ordinary income from debt cancellation with the unrelated concept of gain attributable to the consideration received on the disposition of the property. While in these cases the consideration for the property often takes the form of debt assumption, or its equivalent, the applicable concept is gain on the exchange of property *for a valuable consideration;* and so gratuitous release from liability is not a factor.

The other argument, and the one which seems to have bothered the court in the *Crane* case, correctly treats debt assumption as merely a form of consideration for the property, but maintains that without debt assumption there is no consideration, and, therefore, no taxable benefit and, consequently, no income. What this argument fails to apprehend is that, even in the case of a seller personally liable on the mortgage, the buyer's assumption of the liability is not what gives rise to taxable income on the disposition of the property. Observe that the mortgagor gives up property of a value equal to the debt to get the benefit of the debt assumption. It is quite the same as if the taxpayer, owing $10 to Y, paid this sum to X who assumed the debt. The only difference, where the taxpayer, instead of paying $10 cash to X, transfers to X property worth $10 on the same terms, is that the taxpayer is also disposing of a piece of property.

It is the disposition of the property that gives rise to taxable income in the latter instance. The taxable benefit lies in the payment received for it. The debt assumption, serving as an element of the payment, constitutes good consideration for the property and so figures in the gain or loss from the disposition of the property; but it is not the tax producer. Thus, where the taxpayer paid $10 to X to have him assume an obligation to Y, he got good consideration for his $10, but he did not realize any taxable income because of it. In the same way, where the taxpayer transferred property to X in consideration for X's assumption of a liability to Y, the taxpayer did not realize any income or incur a tax *because X assumed his liability.* He realized income only *because he disposed of his property at a profit.* In fact, had his basis been greater than the market value of the property, he would have realized a loss.

An owner of mortgaged property will receive the same amount of consideration on the disposition of his property whether or not he is personally liable on the mortgage. Debt assumption may be lacking as an element of consideration in cases of unindebted mortgagors; but that does not make for an absence of any consideration, unless the unindebted mortgagor is to be assumed to have given up his property without receiving any consideration to the extent of the amount of the mortgage. This is obviously absurd, because the unindebted mortgagor has no less to sell, and is entitled to no less consideration, than the indebted mortgagor. The latter can command no more cash over and above the mortgage than the former. In each case, the amount of the mortgage is automatically an offset against the amount of cash that would otherwise be paid for the property. The amount of this offset is readily conceded to be part of the consideration received by the latter, because it represents a debt for which he is personally liable. But the owner's personal liability, or lack of it, obviously has no bearing on the amount of consideration he is entitled to receive for his property. The only thing that affects this is its intrinsic value; and the owner is fully compensated for his property if he receives on its transfer the amount of the intrinsic value in cash and lien extinguishment.

That the lien extinguishment is without *personal* benefit to the unindebted transferor is no bar to its recognition as part of the consideration received or the property. The mortgage, even though not personally owed, is, after all, primarily payable out of the charged property, and so is in a sense a debt of the property owner with merely the source of payment limited. It is important not to forget that any personal liability of the person who previously conveyed the property to the unindebted owner has become only a surety liability.[19]

One could reify the land by calling the realty the principal debtor; but it is more helpful to view as the principal debtor the person whose property can be appropriated as the primary fund for the payment of the mortgage debt. Since his liability is limited to the realty, the owner may be called a "real" principal to distinguish him from a personal principal. In terms of a taxpayer's net worth, he is just as well off to get, in exchange for the property, release from a debt collectible only out of that property (assuming the property is worth at least as much as the debt), as he is to have a debt for which he is personally liable assumed by another or discharged.

7. Gain on "Non-taxable" Dispositions

So long as the taxpayer makes a taxable disposition of his mortgaged property, we have seen that he will be called upon to account for the full profit he enjoyed from the property, either by reason of having mortgaged it somewhere along the line for more than its adjusted cost to him, or by reason of having taken depreciation deductions in excess of his investment in the property, or by reason of any of the other profit-making transactions with mortgaged property which are reflected in a negative basis. We have seen that the taxpayer is equally accountable whether his transferee assumes the mortgage liability, or merely takes subject to it, and even when the taxpayer himself is not personally responsible for the mortgage.

However, how is the taxpayer to be called to account for these profits when he makes a non-taxable disposition of the mortgaged property. Thus, suppose the taxpayer, after refinancing property that cost him $100,000 with a new mortgage for $175,000, carrying no personal liability, gives the property to his son. He has pocketed $75,000 cash in the transaction, and yet there appears to be no basis for collecting a tax (except the gift tax), as we shall see in the discussion under Section 11 ahead.

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[19] *Ibid.*

The new Revenue Act forecloses (at least, for transactions after June 22, 1954) two other types of dispositions that have been thought in the past to effect avoidance of tax on mortgage profits, one where a corporation distributes as a dividend in kind property subject to a liability in excess of the corporation's basis therefor, and, two, where an individual or corporation makes a non-taxable contribution to a controlled corporation of overmortgaged property.

Distribution by corporation. The new statute adopts as a general rule the propostion of the *General Utilities & Operating Company* case[20] that a corporation derives no taxable income by reason of its distribution to stockholders of property which has appreciated over its cost.[21] However, exception is made for the cases where the property distributed carries a mortgage that exceeds the corporation's adjusted basis for the property. The Senate Committee Report says that this exception "imposes a tax where property distributed is subject to a liability in excess of its *cost* to the corporation" [22]—for example, where the property was purchased for $10,000 cash over a $15,000 mortgage, but is subsequently mortgaged for $50,000, and is then distributed as a dividend. Actually, the statute is broader than this, reaching cases, for example, where the property originally cost $60,000 ($10,000 in cash, and $50,000 in a standing mortgage), and by reason of some 20 years depreciation has an adjusted basis of $25,000 when it is distributed to its stockholders (still with the original $50,000 mortgage); because the statute is operative when the mortgage exceeds not merely the cost, but the "adjusted basis" which reflects depreciation deductions.

It is difficult to argue against the fairness of a tax to the corporation at the time of distribution of property against which it has been able to raise in loans more than the original cost; and if this profit is not then taxed, it will never again be capable of being taxed, since the recipient stockholder pays tax only on the equity in the property on its receipt as a dividend.[23] There is, perhaps, less obvious justification for imposing a tax on the distributing corporation where the spread between the amount of the mortgage and the lower basis is partly or entirely a consequence of depreciation deductions (which deductions might not even have been productive of tax benefit)[24] for the corporation has not then made a cash profit over its original investment, but has at most benefited by tax savings, if any, of 30 per cent (or 52 per cent, if the surtax is applicable) of the amount by which depreciation deductions have exceeded the cash investment. There is no compelling reason for making the corporation account for the *excessive* depreciation on a distribution to its stockholders as long as the rule does not require it to account for its depreciation deductions generally on such occasions.

Even less can be said in favor of imposing the tax where the mortgage on the property is not one that stems from a secured borrowing against the property, but has arisen, for example, in a transaction where the corporation has mortgaged a portion of its property to secure performance of a contract; yet the statute by its terms applies to *any* liability to which the distributed property is subject. In fact, the statute on its face is operative even where the property distributed is not subject to any liability, but the shareholder has assumed a liability of the corporation in connection with the distribution, as where the shareholder agrees to pay a note owed by the corporation in partial consideration for the distribution of the property.

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[20] *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200 (1935).

[21] 1954 IRC § 311.

[22] S. Rep. No. 1622, 83d Cong., 2d Sess. 46 (1954).

[23] 1954 IRC § 301(b)(2).

[24] 1954 IRC § 1016(a)(2) requires basis adjustments at least to the extent of depreciation allowable irrespective of tax benefit, and for any additional depreciation deductions allowed which resulted in tax benefit. Similarly, see 1939 IRC § 113(b).

Apparently a distribution of overmortgaged property in liquidation or partial liquidation of the corporation is not productive of taxable gain for the corporation. The realization rule is physically within the section and Part of the Code dealing with the effect on a corporation of a "distribution with respect to its stock."[25] While there is nothing in the content of this phrase that excludes liquidating distributions,[26] a separate Part of Subchapter C of the Code deals with corporate liquidations, and this Part contains its own rule[27] for the effect of a liquidating distribution on the corporation, which makes no reference to distributions of overmortgaged property. That the omission of any such reference is deliberate is made clear by the fact that both of these distribution sections are derived from a single section in the House draft,[28] which stated the rule for both liquidating and nonliquidating distributions; and in this section the special rule for overmortgaged property is explicitly made inapplicable to liquidating distributions. The significance of this is that where the corporation makes a distribution in respect of its stock that might qualify as either a distribution in partial liquidation or simply as a normal distribution—e.g., the redemption of all the stock of a single stockholder —it is imperative to attempt to bring the distribution under the partial liquidation provisions, as can be done where the transaction involves a contraction of corporate activities.[29]

Contribution by stockholder. The tax-free transfer of mortgaged property by a stockholder to his controlled corporation is a device that presumably might have caused tax to be avoided on the profit realized by mortgaging the property for more than its cost, in cases of transactions preceding the new Revenue Act. Assume that property purchased for $25,000, subject to an existing mortgage of $75,000, is mortgaged for an additional $100,000 when the property appreciates in value to $200,000. If the property is then transferred in exchange for stock worth $25,000, the owner has converted a cash investment of $25,000 into mortgage money of $100,000 and stock worth $25,000, for a net gain of $100,000—presumably with no tax. If he later sells the stock for $25,000 (its value when he received it), he will probably report a taxable gain of only $25,000, because, unless the tax law over-comes its dislike for a negative basis,[30] his basis for the stock will have been zero, computed as follows:[31]

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[25] 1954 IRC § 311, in Part I of Subchapter C.

[26] Because a "distribution with respect to stock" could as well refer to a liquidating distribution, Congress has expressly made section 301, which is the general section dealing with distributions, inapplicable to liquidating distributions. 1954 IRC § 331(b).

[27] 1954 IRC § 336.

[28] H.R. 8300 § 308 as passed by House; see S. Rep. No. 1622, 83d Cong., 2d Sess. 247-8, 258 (1954).

[29] Redemption of all the shares of a stockholder qualifies under § 302(b)(3); but § 346(c) provides that qualification under § 302 does not preclude qualification as a partial liquidation. See S. Rep. No. 1622, 83d Cong., 2d Sess. 262 (1954).

Basis of property transferred for stock	100,000
Less liabilities assumed by corporation	175,000
Basis of stock	0

While the corporation will take over his basis for the property[32] and then might ultimately be charged with the tax its stockholder has avoided,[33] if this corporation were a one-asset corporation (as is usual in the case of real estate corporations), it could easily be judgment-proof.

The transfer to a corporation under the foregoing circumstances conceivably might have invoked tax even under the old law if a tax avoidance purpose predominated on the transfer, to the extent of the full $100,000 gain;[34] but under the new law, a taxable gain will result immediately on the occasion of the transfer in every case (whether by an individual or corporate transferor), irrespective of a tax avoidance purpose, though only to the extent of the $75,000 difference between the amount of the mortgage and the basis for the property.[35] Even under the new law, if the Commissioner can sustain a finding of tax-avoidance purpose, tax is imposed under the tax-avoidance section, in lieu of under the "liabilities in excess of basis" section.[36]

8. Coupling Negative Equity with Negative Basis

The problem whether to charge the owner with gain by including the full amount of the mortgage in the consideration received on the occasion of a taxable disposition is compounded where the property is worth less than the mortgage, and the mortgagee nevertheless accepts a conveyance of the property in full discharge of the debt. The problem also comes up on foreclosure. Illustrative figures to consider are: basis 6, value 7, and mortgage 10.

There is obviously something paradoxical about charging a taxpayer with gain from the sale or exchange of property in a year in which he loses his property to the mortgagee and receives nothing of any tangible value; that is, his net assets are not increased; generally no money or other property comes to him as a result of the foreclosure sale; and if he is not personally liable on the mortgage, no debt for which he is in any way liable is discharged. On the surface, all that happens is that he loses an asset for which he receives nothing.

Nevertheless, the courts which have been bold enough to face up to the problem of the disposition of property mortgaged for more than its fair value, have held that the owner "realized" an amount equalling the full value of the mortgage, though receiving no other consideration, and notwithstanding that he was not personally indebted under the mortgage. Understandably, the courts have tried to avoid this problem by refusing to acknowledge the existence of a negative equity in several cases. In the *Crane* case, the court jumped on the buyer's willingness to give some "boot" as proof of a positive equity. In *Parker* v. *Delaney*,[37] where the taxpayer took over property held by a bank after foreclosure, giving back only a mortgage and no cash, and then operated it for about 10 years, quitclaiming it to the bank when the mortgage was in default, the court said there was no evidence that the value of the property was less than the mortgage! And in *Woodsam Associates, Inc.*,[38] whose facts are set forth *infra*, the Tax Court refused to make a finding as to the value of the property, notwithstanding unchallenged testimony that it was worth roughly $60,000 less than the mortgage.

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[30] See footnote 1.

[31] 1954 IRC § 358(a)(1), (d); 1939 IRC § 113(a)(6).

[32] 1954 IRC § 362(a)(1); 1939 IRC § 113(a)(8).

[33] See *Mendham Corp.*, 9 T.C. 320 (1947).

[34] 1939 IRC § 112(k).

[35] 1954 IRC § 357(c)(1).

[36] 1954 IRC § 357(b), (c)(2)(A).

Even where the owner is personally liable on the mortgage, it is difficult to justify a finding that the owner has "realized" the full amount of the mortgage in consideration for the assignment of his property; for it seems perfectly obvious that where the mortgagee accepts the property in full discharge of the mortgage, though it is not worth as much as the debt, the owner has received the benefit of some debt cancellation.

If the property is worth less than the debt, the creditor only receives *pro tanto* consideration for his debt—on the above figures, only 7 out of the 10. Conversely, the only consideration he gives to the property owner is *pro tanto* discharge of the debt; the balance of what he gives to the property owner is gratuitous forgiveness of the unsatisfied portion of the debt. The property owner does not get this portion of the debt discharge as consideration for his property, any more than, if he had paid the creditor an equal amount in cash, it could be said that the *full* amount of the debt discharge was attributable to and given in consideration for the cash payment.

The cases have, nevertheless, ignored the debt forgiveness feature, and called the entire amount of the difference between the basis and the mortgage capital gain on the disposition of the property.[39] In a loose sense, of course, the debt is being given up for the property, and perhaps the simplicity of operation warrants the merging of the debt cancellation and the true consideration. The only effect of this is to convert ordinary income into capital gain (with judicial sanction).

But where the owner is not personally liable, it is hard to justify counting the full amount of the mortgage, even under any relaxed theory of consideration. His debt is limited to the value of his property since that is the only source of its payment. Any excess of the mortgage over the value of the property must be extinguished willy-nilly, and cannot be productive of debt cancellation income.[40] Consequently, to charge him with the full amount of the mortgage constitutes more than just converting ordinary debt cancellation income into capital gain. A footnote in the *Crane* opinion made passing reference to this problem, in the following terms:

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[37] 186 F. 2d 455 (1 Cir. 1950).

[38] 16 T.C. 649 (1951), aff'd 198 F. 2d 357 (2 Cir. 1952).

[39] *O'Dell & Sons Co.*, 8 T.C. 1165 (1947), aff'd 169 F. 2d 247 (3 Cir. 1948) (foreclosure); *Peninsula Properties Co.*, 47 B.T.A. 84 (1942) (voluntary conveyance).

[40] See *Fulton Gold Corp.* 31 B.T.A. 519 (1934); *P. J. Hiatt* 35 B.T.A. 292 (1936); *Hotel Astoria, Inc.* 42 B.T.A. 759 (1940).

Obviously, if the value of the property is less than the amount of the mortgage, the mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot.

The cases decided after the *Crane* case refused to follow this dictum, as we shall see; but, curiously, the footnote has taken root in the new Revenue Act; for it is there provided in the case of a corporate distribution to its shareholders of property with a mortgage in excess of basis (which, as noted above, is now made the occasion for imposition of a tax at the corporate level), that the amount of gain recognized on account of this spread shall not be greater than the amount by which the fair market value of the property exceeds its adjusted basis, if the recipient shareholders do not assume personal liability for the mortgage.[41] This limitation is not restricted, as was the above reference in *Crane*, to cases where the corporate distributor itself bears no personal liability for the mortgage indebtedness. Thus, even if the corporation is liable on the bond, its taxable gain will be measured by the excess of the fair market value over basis, if the recipients do not personally assume the mortgage liability.

Actually, it makes sense to so limit the gain in case of a transferor personally indebted for the mortgage, whether the transaction is one of these distributions to stockholders covered by the statute or a sale of the property to a stranger. Remember that in both such transactions, the recipient of the property is not the mortgagee, and the mortgage liability survives the transaction. Since the property is worth less than the mortgage when the transaction occurs, and, as events stand then, it is likely that the transferor will be called upon to satisfy a deficiency judgment in the future, it is reasonable not to charge the transferor at that time with receipt of taxable benefit in the full amount of the mortgage, only to give the transferor a compensating loss when it is subsequently required to make good a deficiency judgment. (Query: if, because of subsequent appreciation of the property, or payment of the mortgage by the recipient, the transferor is not subsequently obliged to pay a deficiency, can it be charged with debt cancellation income?)

The real question is whether there is any reason to limit the gain of a transferor *not* personally liable for the mortgage debt, where the value of the property is less than the unpaid mortgage. It is true, as the Supreme Court stated in the *Crane* opinion, that the actual benefit to the transferor of overmortgaged property cannot equal the full amount of the mortgage if he is not personally liable for the mortgage. On the other hand, if realization is measured in terms of the actual enjoyment of benefit, fair market value is an equally unreliable figure; because the unindebted owner of overmortgaged property is totally unconcerned with how much less than the mortgage the property is worth, since he will not have to make good any deficiency. His enjoyable benefit is no greater because the property is worth only $10 less than the mortgage rather than $1,000 less.

His benefit was derived from placing a mortgage on the property for more than its cost to him; and the cases which have had to decide the problem of the amount of gain realized by an unindebted property owner on the occasion of the transfer or foreclosure of his encumbered property have recognized this and charged him with gain measured by the full amount of the mortgage. Thus, if this new provision in the law is meant to apply to unindebted owners,[42] we will now have this disparity in the field: if the unindebted owner is a corporation, and holds the property until foreclosure, it will be charged with a gain measured by the full amount of the mortgage; but if it distributes the property to its stockholders in anticipation of foreclosure, realization of a portion of this gain can be avoided.

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[41] 1954 IRC § 311(c).

In one of the earliest cases to find a gain measured by the full amount of the mortgage under the circumstances of a negative equity, the taxpayer had acquired improved real property on its organization in August 1924. Its cost was not indicated in the opinion. Five months later, in January 1925, the taxpayer received a loan of $361,000, to secure which it gave its bond and mortgage on the property. In 1934 the debt was reduced by amortization to $300,000, and the taxpayer was released of personal liability on the mortgage. In 1937, when the mortgage was past due, the taxpayer transferred the property to the mortgagee in lieu of foreclosure. The property was then worth $97,000, and had an adjusted basis of $257,435.42. The Tax Court held that the taxpayer realized a gain in 1937 in the amount of the difference between the basis and the debt.[43] It noted, in passing, that "the $300,000 was received by the petitioner in 1925, but the taxable transaction took place in 1937." It also observed that the release of personal liability in 1934 was not an event having tax consequences.

In the *Woodsam* case, *supra*, the Second Circuit expressly declined to follow the implications of the above-quoted *Crane* footnote, where the taxpayer's predecessor had placed a mortgage for more than cost during his ownership of the property in question, and taxpayer subsequently dropped the property on foreclosure when it was worth less than the mortgage. The court required the taxpayer, which was not personally liable on the mortgage (nor had its predecessor been so liable), to include the full amount of the mortgage in the "amount realized," and report gain on this basis.

There is obvious practical and equitable justification for the results, because otherwise the taxpayer might escape accounting for excessive depreciation, or for the mortgage profit he realizes when he mortgages over cost. A way of reconciling the demands of legal theory and equity has been suggested by the author elsewhere.[44]

The First Circuit, to achieve an equitable result which would prevent a taxpayer from avoiding accounting for depreciation deductions taken in excess of any cash investment, would even require an unindebted mortgagor to report income on an abandonment of the mortgaged property, but would make the income reportable as ordinary income rather than capital gain (where the property is a capital asset) for the reason that an abandonment does not constitute a "sale or exchange."[45]

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[42] The statutory language providing for a limitation on the realization of gain was added to the bill by the Senate Finance Committee, as a modification of the original provision which was section 308(c) of the House bill, without any explanation, or even reference, in the Senate report; so statutory intent here is doubtful. The comparable provision dealing with contributions of mortgaged property to controlled corporations, Section 357(c)(1), does not contain a clause limiting the realization of gain on the nonassumption of the mortgage by the recipient corporation.

[43] *Lutz & Schramm Co.*, 1 T.C. 682 (1943).

[44] Lurie, "Mortgagors with 'Negative Equities' and 'Negative Bases,'" *Proc. N.Y.U. 10th Ann. Inst. on Fed. Taxation* 71, 86-87 (1952).

The Court viewed ordinary income on an abandonment of property carried with a negative basis as simply the converse of the ordinary loss found in cases of the abandonment of mortgaged property with a positive basis.[46] It is submitted that there is no real converse to an abandonment loss, any more than there could be a converse to a casualty loss. Perhaps the answer is to declare that mortgaged property cannot be "abandoned," within the meaning of that concept for tax purpose. That is, if the property has any value, the mortgagee will claim it and satisfy his debt out of it; and to this extent the owner receives consideration even on an abandonment, with the result that he has capital gain or loss the same as on a sale or exchange.

Collateral support for this position is found in the *Oregon Mesabi Corporation* case,[47] where the Tax Court, dealing with a contention of taxpayer that its quitclaiming of overencumbered land to the county for taxes amounted to an abandonment since it received no consideration, saw no substantial difference between this and a foreclosure. Said the Court:

> In the present case, petitioner, in order to avoid foreclosure for unpaid taxes, conveyed the property to the County. If it had not made the conveyance and the County had foreclosed in the same year, there is no question that its loss would have been a capital loss. We cannot see why a different result should be reached because of the giving of the quitclaim deeds. The conveyance to the County was as much a "forced" conveyance as a foreclosure sale would have been. The fact that a consideration did not move to petitioner is immaterial.

Had such a fundamental approach prevailed in the decision of other cases of loss on the disposition of overencumbered property, this field would not now be cluttered with rules by which the receipt of a little "boot" may change an ordinary loss into a capital loss, and where a voluntary conveyance in lieu of foreclosure is one thing, but a foreclosure is another, and an abandonment is something else again.

9. Taxable Gain on Placing Mortgage

We have seen that much of the tortured logic employed to reconcile the finding of a taxable gain with the "debt discharge" test of realization, in cases where the property owner was not personally indebted and so not needful of discharge, was resorted to lest the owner otherwise escape accounting for a prior profit taken out of the property. This has raised the question, whether the placing of a mortgage for an amount in excess of basis without personal liability can result in the taxation of the amount of such excess *at the time of placing the mortgage?*

The Second Circuit has decided, in the *Woodsam* case, supra, that the tax is not warranted in the year of mortgaging the property, on the theory that the debt arising on a mortgage borrowing prevents the transaction from giving rise to gain. The taxpayer there had contended that the mortgage profit was sufficiently realized to have warranted its taxation in the earlier year of the borrowing, as against the contention of the Commissioner that this mortgage profit should be accounted for when the taxpayer lost the property in foreclosure. In simplified form, the facts were that an individual acquired property for a total purchase price in cash and mortgage liability of $300,000, and subsequently refinanced the mortgage, getting a new mortgage of $400,000 without personal liability. Thereafter the individual contributed the property to his corporation in a tax-free transfer, the corporation taking subject to but not assuming the mortgage. The property was still later foreclosed when the mortgage was substantially unchanged, but the property had fallen off in value quite considerably.

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[45] *Parker* v. *Delaney*, 186 F. 2d 455 (1 Cir. 1950).

[46] See *Polin* v. *Comm'r*, 114 F. 2d 174 (3 Cir. 1940); *Rhodes* v. *Comm'r*, 100 F. 2d 966 (6 Cir. 1939).

[47] T.C. Memo, P-H, par. 43,356, C.C.H. Dec. 13,385(n).

One would suppose that, but for the loss of revenues in that particular case, the Commissioner would have been happier to advocate the earlier tax, for which support can be adduced.[48] In the first place, that is the time when the taxpayer has his money and is therefore best able to pay his tax. If the Government must wait for its tax until the ultimate disposition of the property, which may be many years later, the taxpayer may become financially unable to pay the tax. The taxpayer may quite legitimately make gifts of the mortgage money immediately upon his receipt of it; and transferee liability could not be availed of by the Government against the donee, since no liability for the tax could be said to have accrued at the time of these gifts. The disposition of the property itself will not provide the mortgagor with the necessary tax money if the value of the property is not then sufficiently in excess of the mortgage to produce the requisite cash.

Our entire income tax structure is based upon self-assessment and honest voluntary compliance. If taxpayers were clearly told that the law required an immediate tax upon receipt of mortgage proceeds in excess of basis, there is no doubt that the vast majority of them would so report their income. They would surely understand a rule which taxes their gain when they have the money to pay the tax, more readily than they can understand that income may be realized when they lose their property without a penny's worth of economic benefit at the time of the loss.

Furthermore, enforcement of the tax is facilitated by a levy in the year the mortgage proceeds are received. In the case of individual returns (where comparative balance sheets are not available), the Bureau's best check on income which a taxpayer fails to report is cash receipts. If the taxpayer has received cash during the taxable year which is not reported as income, he must offer an explanation. One possible explanation is that it represents a loan; another is that it represents a return of capital. If the mortgage transaction does not qualify for either of these explanations, the revenue agent could assert a deficiency.

It is likely that the Commissioner will some day regret his victory in the *Woodsam* case sufficiently to reverse the position he took there and seek to collect a tax on the placing of a profitable mortgage—at least, if the mortgagor is not personally indebted for the mortgage obligation. Whether the Commissioner could successfully take the same tack where the mortgagor is personally indebted is more difficult to say; but the discussion in Section 6 above should show the fallacy of emphasizing a property owner's personal liability, or lack of it, for the mortgage on his property. The property itself is the primary fund for the payment of the debt; and since its value is likely to be well above the amount of the debt when the mortgage is placed, the personal liability of the owner *at that time* should count for little, its only practical significance being that the owner may be exposed to a deficiency judgment in the remote and unlikely eventuality of a subsequent decline in value that outpaces the amortization of the mortgage. Even this contingent liability may be lacking for practical purposes where the mortgage bond represents a corporate liability and the obligor puts the mortgage loan beyond recovery—other than as a claim against the property—by distribution of the loan proceeds to its stockholders.

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[48] See Note, 6 *Tax L. Rev.* 319 (1951).

10. Corporate Distribution of "Windfall" Mortgage Profits

One type of case where the Commissioner has sorely felt the effects of his victory in the *Woodsam* case is that of corporate distributions of the gains of "mortgaging out" on projects built with government-insured loans. Testimony before the Senate Banking Committee showed that corporations constructing so-called Section 608 projects and others obtained bigger mortgages than their entire costs of the land and buildings. The question arose whether the stockholders could be charged with a dividend on the distribution of these excess mortgage proceeds.

Applying the rationale of *Woodsam*, it becomes impossible to find the requisite corporate earnings to support treatment of the distribution as a dividend in the stockholders' hands, since the placing of the mortgage does not give rise to realizable profit. To tax the distribution as a dividend, in years prior to enactment of the 1954 Code, the Commissioner was forced to argue that either the distribution of the proceeds of mortgage borrowings against unrealized appreciation was like a distribution in kind of appreciated assets and hence taxable as a dividend because not impairing capital, or, alternatively, that the "collapsible corporation" statute extended to such distributions so as to impose liability for ordinary income tax on the recipient stockholders. In the famous *Gross* case[49] involving taxable years prior to the enactment of the collapsible corporation statute, the Tax Court refused to apply the dividend-in-kind rationale and permitted the taxpayers to "mortgage out" at capital gain.

The decision makes no reference to the Commissioner's Regulations,[50] which, with dubious sanction in the pre-1954 statute, asserted that liability for ordinary income tax under the "collapsible corporation" section may lie on the receipt by stockholders of a distribution of excess mortgage proceeds. Of course, the *Gross* case involved a transaction prior to the effective date of the "collapsible" provisions; but it is doubtful in any event that the Regulations would be sustained as a proper interpretation of the statute.

It must be conceded that the anticipation of a construction profit through the placing of a high mortgage, and the attempted conversion of this sum into capital gain for the stockholders via the expedient of a distribution of the mortgage proceeds before any "realization" of the profit by the corporation, is not such a far cry from the realization of this identical profit via a stock sale, or via a corporate liquidation on the basis of a valuation that reflects this profit. In fact, since to the extent property distributed in liquidation is encumbered it is not reportable by the stockholders, the amount of the mortgage goes to reduce the profit reportable on liquidation; and so it is quite logical that a distribution of the mortgage proceeds be treated in the same manner as a liquidation of the corporation. However, while the statute under the old Code expressly covered the cases of the sale of stock, or the liquidation, of a collapsible corporation, it did not cover a distribution in respect of stock other than in liquidation.

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[49] 23 T.C. # 97 (1955); see Lurie, "The Messrs. Gross and Morton: Modern '49ers," 33 Taxes 666 (1955).

[50] Reg. 118, Sec. 39.117(m).

The Commissioner's road is made considerably easier for the future, however, by two new provisions in the 1954 Code, which strike directly at the distribution of mortgage proceeds amounting to more than the corporation's basis. There is, first, the imaginative provision that creates constructive earnings and profits for a corporation whenever it makes any distribution to stockholders at a time when there is outstanding a government-insured loan that exceeds the cost of the property securing the loan.[51] The effect of this (if the statute is constitutional)[52] will be to assure the taxation as a dividend of a distribution of excess loan proceeds to stockholders. The statute applies only to distributions made after June 22, 1954, but the proceeds may stem from mortgage loans placed at any time before that date.[53]

There is, secondly, a broadening of the provisions of the "collapsible corporation" section under the new Revenue Code to include a distribution to stockholders that would otherwise be treated as a return of capital.[54] The Senate Finance Committee report[55] says that this provision is designed to supplement the above-mentioned section creating constructive earnings and profits. It applies, for example, to a distribution of the proceeds of any loan exceeding the property basis irrespective of whether the loan is government-insured, made, or guaranteed.

Unlike the new statute relating to corporate distributions of negative basis property (discussed in Section 7, above), the constructive earnings section applies only where the corporation holds property with a negative basis by reason of the fact that the mortgage loan exceeds the actual cost of the property. The statute is expressly made inapplicable where the basis for the property is less than the mortgage because of the effect of adjustments for depreciation.[56] This carries out the purpose of the statute, which is "to tax distributions of proceeds of loans insured by the United States where the amount of the loan exceeds the cost of the property by which it is secured."[57]

However, there is no need to trace any particular distribution to the proceeds of the loan.[58] Any distribution while there is a loan outstanding in excess of cost will have the effect of creating earnings in the amount of such excess, with the result that the distribution must be treated as being out of earnings and profits, and so taxable as a dividend.[59] The earnings so "created" are immediately "eliminated" after the distribution; and if there is a subsequent distribution while the loan is so outstanding, the fiction of creating and wiping out the earnings is again resorted to.

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[51] 1954 IRC § 312(j).

[52] See text accompanying footnote 63.

[53] See S. Rep. No. 1622, 83d Cong., 2d Sess. 251 (1954).

[54] 1954 IRC § 341(a)(3).

[55] S. Rep. No. 1622, 83d Cong., 2d Sess. 260 (1954).

[56] The statute provides that for this purpose "adjusted basis" shall not reflect adjustments for depreciation.

[57] S. Rep. No. 1622, 83d Cong., 2d Sess. 47 (1954).

[58] Id. at 251.

[59] Id. at 47.

Neither the statute nor the Committee Report anywhere states that the amount of constructive earnings that can be created on the occasion of any subsequent distribution is reduced by the amount of any prior distribution; but it is obviously the intent of the statute only to create artificial earnings to the extent of the excess of the loan over cost;[60] and presumably the statutory omission in this respect will not prove costly to taxpayers.

The timing of the distribution can be very important. While nowhere expressly stated, the underlying assumption of the statute appears to be that at the time the corporation makes the distribution of the loan proceeds, it is in possession of the property on which it obtained the loan. Hence, if the corporation first disposes of the mortgaged property, either by an arm's length sale or by a distribution of the property to its stockholders, and subsequently distributes the loan proceeds to its stockholders, it presumably cannot be subjected to the constructive earnings increase. This is only fair, because the disposition of the mortgaged property will itself cause a "realization" of income by the corporation in the full amount of the mortgage,[61] and will cause a consequent normal increase of its earnings and profits.

On the other hand, if the corporation first distributes the loan proceeds, and then disposes of the property, strange things happen to its surplus account. On the occasion of the distribution of the loan proceeds, its capital and surplus are left entirely unaffected by reason of the artificial temporary increase of earnings and profits, notwithstanding the fact that a portion of its assets have thereby been disposed of. When the corporation then disposes of the property, it "realizes" the gain inherent in the prior mortgaging for more than cost (as well as any additional consideration over the mortgage, received on the disposition) which causes an increment in its earnings and profits to the extent of this gain. So its situation then is to be left with a book surplus though in actuality it has previously distributed the earnings that made for the surplus.

This raises the question whether it is not proper to allow some adjustment to the earnings and profits account after the corporation completes a transaction that enables it to catch up with the constructive entries in the account that the new statute prescribes. Thus, since the increase and decrease, respectively, that would occur in the surplus account, on the occasions of a disposition of mortgaged property and of a distribution of the proceeds to stockholders, have already occurred, should it not follow that a disposition of overmortgaged property following the prior distribution to stockholders of the excess mortgage proceeds does not require a credit to surplus? Similarly, suppose that the "windfall" mortgage profit that has been distributed to stockholders is repaid by the corporation by a full satisfaction of the mortgage debt at a subsequent time; should that not be the occasion for a charge to surplus?

We have seen that these knotty accounting problems apparently can be avoided by a disposition of the mortgaged property prior to the distribution of the "windfall"; but this occasions the realization of a gain to the corporation. It is possible that this gain can be avoided if the statute is taken literally. Thus, suppose that the corporation that has built the property and received the mortgage then liquidates into a parent corporation. If the parent, having thereby acquired the mortgaged property and the surplus mortgage proceeds, then distributes the mortgage proceeds to its stockholders, it is barely possible that the artificial dividend can be avoided; because the recipient corporation may not be regarded as the corporation to which "there is outstanding a loan" in the qualifying words of the statute.[62] However, even if this result is possible, tax-wise, the freedom to take advantage of it may be restricted by provisions inserted in the borrowing corporation's charter at the insistence of the government lending agency.

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[60] Id. at 251.

[61] See discussion in Sections 6 and 7 of this chapter.

Perhaps the best chance of avoiding the impact of this statute is to challenge its constitutionality. It taxes as dividend income in the hands of stockholders a distribution derived from a corporate borrowing. Where the distributing corporation has not had earnings currently or in the past, it is incapable of distributing to its stockholders anything that partakes of the nature of income in the hands of the stockholders. Thus, the distribution must be in the nature of a return of capital. While Congress can undoubtedly tax returns on capital at ordinary income rates, it must allow a tax-free recovery of the original capital, since constitutionally Congress cannot tax capital.[63]

If some taxpayer should succeed in overturning this statute, his victory may prove empty unless he holds off distributing the "windfall" for at least three years, or can otherwise shed the "collapsible corporation" cloak; because what the "artificial dividend" section does not catch, the new revised "collapsible corporation" statute well might. The expansion of the "collapsible corporation" statute to impose ordinary income tax on distributions not in liquidation, which are in the nature of returns of capital in excess of basis, was designed to reach corporate distributions of excess mortgage profits, whether or not the mortgage is insured, guaranteed, or made by the United States. This provision is intended to supplement the "artificial dividend" section.[64] It applies to all corporate distributions which are not dividends; and by limiting the tax to distributions in excess of basis, it avoids the constitutional hurdle of the "artificial dividend" section. Where the section applies, it is not necessary to show the source of the loan or the borrower, or the relation of the amounts of the mortgage and the cost, but simply that the distribution to the stockholder exceeds his adjusted basis for the stock. Of course, the corporation must otherwise meet the statutory tests of a collapsible corporation and satisfy the conditions to its becoming operative.[65]

11. Tax Avoidance Techniques

The recent legislation has considerably narrowed the area of potential legitimate tax avoidance. Nevertheless, as long as the rule of the *Woodsam* case stands to allow mortgaging at a profit without tax liability, avoidance opportunities will be presented.

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[62] The statute is literally applicable only where "there is outstanding a loan to such corporation," in the context "such corporation" referring to the distributing corporation .

[63] See *Eisner* v. *Macomber*, 252 U.S. 189 (1920); cf. *Lela Sullenger*, 11 T.C. 1076 (1948).

[64] See footnote 55.

[65] This means, generally, that the corporation must be "formed or availed of principally for the manufacture" of property, with a view to realization by the stockholders at capital gain rates of the gain that would otherwise accrue to the corporation; more than 70% of the stockholders' gain during the taxable year must be attributable to such manufacture; and the stockholders' gain must not have been realized more than 3 years after completion of such manufacure. 1954 IRC § 341(b)(1), (d).

Suppose a taxpayer buys real property for $25,000 cash, subject to an existing mortgage of $75,000. When the property appreciates in value to $200,000, he obtains an additional mortgage for $100,000 without personal liability. As of that moment, the taxpayer will have fully recovered his initial cash investment, and will be ahead $75,000 which he need never repay. If the taxpayer now makes a gift of the mortgaged property, there appears to be no theory to support a tax on the $75,000 "boot." Witness the Commissioner's loss of the *Farrier* case,[66] in which he attempted to extend the *Horst* rationale[67] to unrealized appreciation in donated property. The net result is that the $75,000 will never become subject to tax in the hands of the taxpayer. In fact, if the taxpayer contributes the mortgaged property to charity, he may get a tax deduction of $25,000.

It is not safe to assume that the Commissioner will idly watch the proliferation of these forms of tax avoidance. He has already bared one weapon he might use to overcome them, in I.T.'s dealing with the donation of agricultural products and livestock by farmers, in one case to charity[68] and in the other to a son.[69] In each case the Bureau ruled the transaction to be a taxable disposition, in that the "satisfaction" derived from the giving away of the property resulted in the enjoyment of income within the *Horst* rule.

In the view of most tax practitioners *Horst* is a long way from these I.T.'s., because that case really dealt only with the question of the attribution of income where a taxpayer gave away interest coupons but retained the bonds to which they had been attached. *Horst* was just another flowering of Justice Holmes' figure of the retained "tree" and the donated "fruit."[70] In the farmer cases, on the other hand, there is nothing retained in the nature of a tree, and what is given away is not fruit—that is, mere income.

Nevertheless, the Bureau was encouraged in issuing these I.T.'s to find the realization of income in the making of the gifts by the following statement of the Supreme Court in *Horst:*

> Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself, he has nevertheless, by his act, procured payment of the interest, as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son.

There are some tax men who are willing to concede that the kind of "satisfaction" which is sufficient to support the realization of ordinary income should also be sufficient to constitute consideration, or the "amount realized," on the disposition by gift of property. But these men point out that to make a gift an income-realizing event for the donor is violative of the underlying assumption of new Code Section 1015 (formerly Section 113(a)(2)), which, in passing the donor's basis on to the donee, is designed to defer the tax until the donee disposes of the property; and hence, they argue, any change in this rule must come from the Congress and not the Treasury.

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[66] W. O. *Farrier Est.*, 15 T.C. 277 (1950).

[67] *Helvering* v. *Horst*, 311 U.S. 112 (1940).

[68] I.T. 3910, 1948-1 C.B. 15.

[69] I.T. 3932, 1948-2 C.B. 7.

[70] See *Lucas* v. *Earl*, 281 U.S. 111 (1930).

While the Commissioner has been rebuffed in his first attempt to accomplish this change by administrative fiat, in the *Farrier* case mentioned above, where the court expressly repudiated the farmer I.T.'s, this case involved only an attempt to tax *unrealized* appreciation on the occasion of a gift. The taxpayer had not converted this unrealized appreciation into cash in the bank, as would be the case where a profit-taking mortgage precedes the gift to charity or to an object of bounty. Such a coupling of mortgage and gift might well press a court to sidestep the *Farrier* case to catch the tax revenues that might otherwise slip away.

The courts generally today do not "freeze" in face of a mortgage tax problem. While the reasoning is sometimes fuzzy—the *Crane* opinion is the classic example—the judicial instincts for reaching the "right" result have been unerring in recent years. It can be taken for granted that if tax steals are attempted through the medium of mortgages, the courts will be quick to invent a theory to lock the gate.

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How Capital Gains Are Achieved in Breeder Livestock Transactions

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Congress, in the Revenue Act of 1951, amended Section 117(j) of the 1939 Internal Revenue Code to provide specifically for capital gains treatment of certain sales of draft, dairy, and breeding livestock. The language so added to the 1939 Code is now a part of Section 1231 of the Internal Revenue Code of 1954. However, it appears that the Bureau of Internal Revenue, in actual practice, has not changed substantially its pre-1951 position of denying capital gains treatment to most livestock sales. It is the purpose of this chapter to consider the nature of the controversy between taxpayers and the Commissioner with particular emphasis on how to meet the requirements of 1954 IRC Section 1231 and 1939 IRC Section 117(j) as defined by the Commissioner and by the courts.

1. Points to Consider

To accomplish the objective just stated, the following points should be considered:

Section
How does investing in livestock operations differ from other types of investments? 2
What are some of the non-tax considerations in deciding whether to undertake investments in livestock operations? . . . 3
What is the history of the tax controversy concerning capital gains treatment of livestock sales? 4
What significance does the pre-1951 history concerning the application of 1939 IRC Section 117(j) to livestock sales have in applying the law today? 5
What has been the reaction of the Commissioner of Internal Revenue to the provisions of the Revenue Act of 1951 concerning the sale of livestock? 6
What are the essential elements necessary to capital gains treatment of livestock sales? 7
What procedures in livestock operations tend to establish the existence of the elements essential for capital gains treatment? 8
In what kind of livestock operations are there tax dangers? 9
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2. How Does Investing in Livestock Operations Differ from Other Types of Investments?

The essential difference between investing in a breeder livestock operation and investing in most other things where the profit may later be taxed at capital gains rates is that a greater portion of the funds invested in livestock may take the form of ordinary deductions for income tax purposes during the period that capital assets (breeder livestock) are being developed. In other words, the tax objective is to expense raising costs and realize maximum capital gains on sales. This is particularly true where the stockman operates on a cash basis of accounting, as he is permitted to do by the Regulations of the Commissioner of Internal Revenue.[1] Some ways in which this tax treatment may work to the advantage of investors are set forth in the paragraphs immediately following.

Where the investor has income from other sources, he can use his losses from his breeding herd operation in its development stages to offset that income, and thereby reduce his income taxes. There will be operating losses from the breeding livestock operation during those years when a substantial proportion of the offspring is retained to increase the breeding herd. If a taxpayer is using these losses to offset income from other sources which would otherwise be taxed at a high rate, his tax savings obviously reduce his cost of raising the livestock. For example, the actual cost of raising livestock will be only thirty cents of each dollar of operating loss for a taxpayer who can deduct that loss from his livestock operation from other income otherwise taxable at an average rate of seventy per cent. A taxpayer with such a "real" cost of production would have to engage in an extremely inefficient operation to lose money when he either (1) sells animals in transactions resulting in ordinary income in a year when his total income is taxed at rates substantially below the rate of savings achieved in previous years, or (2) sells a substantial number of animals for profits which qualify for capital gains treatment under 1954 IRC § 1231 or 1939 IRC § 117(j) (hereafter referred to collectively as IRC § 1231).

Even though an investor in breeder livestock has no income outside of his cattle operations, tax advantages still exist. In the early stages of his operations he may have very little income from sales of animals, so that a net operating loss results which he cannot use in the current year. However, he can use that loss as a carryback or a carryover, and his cattle operations should be producing both ordinary income and capital gains to which any carryover can be applied long before the carryover from the first year's operations becomes useless from lapse of time.

Although one is engaged in a breeder cattle operation, sales of steers and other animals which are the product of the breeding herd and held for sale to customers in the ordinary course of business will result in substantial ordinary income. Actual sales of animals which have been held for breeding purposes as required by IRC § 1231 will result in capital gains. These capital gains will have been produced by the sale of animals, the raising costs of which have been expensed. Such raising costs as are expensed in the current year, if sufficiently in excess of ordinary income, may be used by non-corporate taxpayers to offset the capital gains income at the rate of one dollar of expense for two dollars of capital gain.[2] Even though the raising costs do not exceed ordinary income, there is still the obvious advantage of removing some of the gain on total sales from top income tax brackets by capital gains treatment of sales of livestock held for breeding purposes.

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[1] Reg. 118 § 39.22(c)-6 and Reg. 118 § 39.22(a)-7.

3. What Are Some of the Non-tax Considerations in Deciding Whether to Undertake Investments in Livestock Operations?

Before tackling the tax problems involved in livestock investments, a few words concerning non-tax considerations may be appropriate. There are obvious difficulties totally aside from tax considerations which must be faced in making a decision to invest in livestock. First of all, there is the problem of whether the investor has sufficient knowledge of the business or can obtain personnel with sufficient know-how to operate the business for him. Secondly, just as in choosing any investment, the status of the market in the foreseeable future must be predicted. The availability of feed and prospective feed prices must be compared with the cattle market. A careful study of original cost of the herd, of facilities to handle it, and of the anticipated margin of profit is essential. In addition, there is a kind of risk to be considered which is not present in most investments. That is the risk of drought, freezing, and disease which might destroy the investment.

4. What is the History of the Tax Controversy Concerning Capital Gains Treatment of Livestock Sales?

In the Revenue Act of 1942, Congress added subsection (j) to Section 117 of the 1939 Internal Revenue Code. That subsection permitted capital gains treatment of the gains during the taxable year in excess of losses from the sale of "property used in the trade or business." Losses during the taxable year in excess of gains from sales of such assets are fully deductible. "Property used in the trade or business" was defined in 1939 IRC Section 117(j) as

> property used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, . . .

(The language concerning livestock added in 1951 will be set forth later.)

A simple example of a Section 117(j) asset is a piece of machinery used by a manufacturer to produce another item for sale to customers. After the Revenue Act of 1942, the question arose as to whether draft, dairy, and breeding livestock were assets comparable to such a machine in a manufacturing plant so as to be within the scope of Section 117(j).

The controversy between the Commissioner and taxpayers has been concerned almost exclusively with breeding animals. In 1944 and 1945 the Bureau published its position on the subject in I.T. 3666[3] and I.T. 3712[4] to the effect that Section 117(j) would not apply to the sale of animals normally culled from the breeding herd. It was the Commissioner's position that capital gains treatment should be reserved for the proceeds of the sale of animals removed from the herd for the purpose of changing the breed or quality of the offspring, or reducing the size of the herd. Great importance was placed upon the latter factor of reducing the size of the herd, on the theory that sales of animals which did not reduce the size of the herd merely represented the product of the machine—the machine-unit being the entire breeding herd rather than individual animals. Therefore, the Bureau attempted to apply a rule of thumb, treating the number of animals sold from the breeding herd in excess of those added to the herd during the year as qualifying as animals abnormally removed from the herd to which Section 117(j) would apply. Taxpayers objected upon the theory that each animal held for breeding purposes was the machine-unit to which Section 117(j) applied.

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[2] This is true where the alternative method of computing the capital gains tax is not used. Therefore, if capital gains are so far in excess of losses as to make necessary the use of the alternative method, the benefit of the losses will be lost.

The above rules formulated by the Commissioner were rejected by the courts in a series of cases[5] on the issue of whether under the particular facts of each case the individual animals sold had been held as draft, dairy, or breeder animals. Significant elements of some of these cases will be cited later on in this chapter. Following these adverse decisions, the Commissioner, on June 27, 1951, issued Mimeograph 6660[6] withdrawing the I.T.'s mentioned above and announcing that Section 117(j) would apply to draft, dairy, and breeding animals which had been held for substantially their full period of usefulness or which had been added to the draft, breeding, or dairy herd for substantial use in the herd. This ruling of the Commissioner was short lived for the reason that Congress in the Revenue Act of 1951, after having considered the problem for several years, amended Section 117(j) and, in the committee reports, clearly rejected the position of the Commissioner under Mimeograph 6660.

Section 324 of the Revenue Act of 1951 amended IRC Section 117(j)(1) by adding to it the sentence: "Such term [meaning property used in the trade or business] also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for twelve months or more from the date of acquisition. Such term does not include poultry." The amendment is applicable to taxable years beginning after December 31, 1941, except that the change in the holding period from six to twelve months and the exclusion of poultry applies only to taxable years beginning after December 31, 1950. Language identical to that of the 1951 amendment just quoted is Section 1231(b)(3) of the 1954 Internal Revenue Code. The Committee Reports on the 1954 Code affirmatively state that no substantive change in the law under 1939 IRC § 117(j) was intended in the enactment of 1954 IRC § 1231.

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[3] 1944 C.B. 270.

[4] 1945 C.B. 176.

[5] *Albright* v. *U.S.* (8 Cir. 1949), 173 F. 2d 339, 37 AFTR 1125; *Isaac Emerson,* 12 T.C. 875 (1949); *Fawn Lake Ranch Company,* 12 T.C. 1139 (1949); *Franklin Flato,* 14 T.C. 1241 (1950); *U.S.* v. *Bennett* (5 Cir. 1951), 186 F. 2d 407, 40 AFTR 74; *Davis* v. *U.S.* (D.C., N.D. Iowa, 1951), 96 F. Supp. 785, 40 AFTR 527; *Mitchell* v. *U.S.* (D.C., N.D. Cal., 1951), 96 F. Supp. 473, 40 AFTR 415; *Walter S. Fox,* 16 T.C. 854 (1951); *A. Harold Schmidt,* par. 51,160 Prentice-Hall Memorandum T.C. (1951); *Miller* v. *U.S.* (D.C., Neb., 1951), 98 F. Supp. 948, 40 AFTR 1151.

[6] 1951-2 C.B. 60.

5. What Significance Does the Pre-1951 History Concerning the Application of 1939 IRC Section 117(j) to Livestock Sales Have in Applying the Law Today?

The history of the dispute between the Commissioner of Internal Revenue and taxpayers who sought during the period 1942 to 1951 to take capital gains on sales of breeding livestock is significant because the Revenue Act of 1951 did not make entirely new law on this subject, rather it clarified to some extent just what the law had been since the Revenue Act of 1942.[7] Therefore, the manner in which the law was construed during the period 1942 to 1951 has been a useful guide in applying Section 117(j) as amended by the Revenue Act of 1951 and will continue to be useful in applying 1954 IRC Section 1231.

It must be kept in mind that except for an initial effort by the Commissioner to deny Section 117(j) treatment to livestock sales, the approach of the Commissioner has been to restrict the definition of animals held for breeding purposes and to enlarge on the definition of animals held for sale to customers as a means of denying Section 117(j) treatment to most sales of livestock. Therefore, the case history which aids in defining exactly what constitutes holding animals for breeding purposes will be very important in the application of Section 117(j) as amended and 1954 IRC § 1231. Some of the more significant cases will be woven into the discussion below of the essential elements necessary to capital gains treatment of livestock sales.

6. What Has Been the Reaction of the Commissioner of Internal Revenue to the Provisions of the Revenue Act of 1951 Concerning the Sale of Livestock?

Having lost the legislative battle, and having lost the battle before the courts over the application of Section 117(j) to sales of livestock held for breeding purposes, after the Revenue Act of 1951 the Commissioner of Internal Revenue turned to attack the use of the cash basis of accounting by stockmen. Congress foresaw the possibility that the Commissioner would seek to amend his regulations existing since 1918, which permit livestock raisers to report on the cash basis of accounting, to prevent the expensing of the cost of raising animals. The Ways and Means Committee and the Senate Finance Committee, in their reports on the Revenue Act of 1951, expressed the desire that established accounting practices currently recognized by the Bureau be continued. Therefore, instead of directly withdrawing the right of stockmen to use the cash basis, the Commissioner took an indirect approach which would have the same result. What the Commissioner did was this: he proposed to amend his regulations so as to require cash basis cattlemen to capitalize the cost of raising their animals held for draft, breeding, or dairy purposes. This proposal, if put into effect, would decrease capital gains and increase ordinary income. In practical operation the Commissioner's proposal would put livestock raisers on an inventory basis of accounting for their herds. Capital gains would then be measured by the difference between inventory value and sales price, rather than the zero basis which the cash basis taxpayer who has expensed all of his costs of raising animals would have.

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[7] The change in holding period and exclusion of poultry by the 1951 Amendment was new law, but the applicability of Sec. 117(j) to draft, breeding, and dairy animals had been established by court decisions some of which are cited in footnote 5, supra.

Reaction against the Commissioner's proposal from all sections of the country was such as to convince the Secretary of the Treasury that the proposal should not be carried out in the form of Bureau Regulations, but should be submitted to the Congress for legislative consideration. Secretary of the Treasury Snyder, on June 27, 1952, wrote to Senator Walter F. George of the Senate Finance Committee and Representative Robert L. Doughton of the House Ways and Means Committee to the effect that Congress should work out some legislation which would require cash basis cattlemen to capitalize the cost of raising animals in order to place accrual basis cattlemen on an equal footing with cash basis cattlemen.

The Secretary's letter pointed to the refusal of the Commissioner of Internal Revenue to permit accrual basis cattlemen to change to the cash basis. Taxpayers urged that a change in Bureau policy to permit taxpayers to change from the accrual basis to the cash basis would achieve in a very simple manner the equality between taxpayers which the Secretary stated was of primary concern to his department. Taxpayers also pointed to the inability of most farmers to maintain records necessary to an accrual method of accounting. Finally, the Treasury, on May 12, 1953, advised the National Livestock Tax Committee as follows:

> The Bureau of Internal Revenue will no longer withhold action on applications by livestock raisers to change their method of accounting for income tax purposes. This revises prior practices under which the Bureau has been refusing to approve requests by livestock raisers to shift from the accrual method to the cash receipts and disbursements method. There have been numerous such requests by livestock raisers to make such shift in their accounting method in order to obtain full advantage of the provisions of section 117(j).
>
> The rules generally applicable to requests to change an accounting method remain in effect, namely, that the application to make such a change is required to be filed within 90 days after the beginning of the taxable year to be covered by the return and the change will not be granted unless the Bureau and the taxpayer agree to the terms and conditions under which the change will be effected.

The ruling just quoted is of great benefit to those livestock raisers who have been operating on the accrual basis of reporting income. By shifting to the cash basis, such taxpayers will be able to decrease their ordinary income and increase their capital gains. While the ruling does not state that the Treasury is abandoning its campaign to modify the cash basis of accounting, if such an intention does not exist many taxpayers will be deceived by the ruling. It is not expected that the Treasury would so lead taxpayers to change to an accounting method which the Treasury has intentions of altering to the disadvantage of taxpayers in the near future. Moreover, it is significant that Congress in its 1954 drastic revision of the Internal Revenue Code did not find it necessary to legislate on this matter. However, the strong feeling on the subject by permanent personnel of the Bureau of Internal Revenue makes it possible that the proposal by Secretary Snyder in 1952 will be given close scrutiny in the future in connection with bills to amend many areas of the 1954 Code.

7. What are the Essential Elements Necessary to Capital Gains Treatment of Livestock Sales?

The purpose of the foregoing pages of this chapter is to describe the background in which the elements necessary to capital gains treatment of livestock sales have been defined. The elements required by the statutory language of IRC § 1231 and its predecessor Section 117(j) are: (1) The object sold must be "livestock"; (2) The livestock sold in taxable years beginning after 1950 must have been held by the taxpayer for twelve months or more (for taxable years beginning before 1951 the holding period was six months); (3) The livestock must have been held by the taxpayer for draft, breeding, or dairy purposes.

Regulations 118, Section 39.117(j)-2 provide that "the term 'livestock' shall be given a broad, rather than a narrow interpretation and includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals." Poultry are excluded by the specific language of IRC § 1231, and the regulations just cited defining livestock provide that "it does not include chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc."

The twelve months holding period for livestock prescribed by IRC § 1231 begins with the date of acquisition of the animal. It is not necessary to have used the animal for draft, dairy, or breeding purposes for twelve months.[8]

IRC § 1231 itself is some help in defining the term, "held by the taxpayer for draft, breeding, or dairy purposes." The statute provides that the age of the animal does not matter so long as it was held for one of the prescribed purposes. This point is further emphasized by the separation of the language prescribing the holding period from the purpose of holding regardless of age clause. To this extent Congress provided objective standards to guide in the application of the statute. Beyond this the taxpayer must consider the Regulations and the cases to determine the circumstances under which animals are deemed to have been held for draft, breeding, or dairy purposes.

The applicable Regulations under the 1939 Code are set forth in the footnotes.[9]

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[8] See Report of the Committee on Finance, United States Senate, to accompany H.R. 4473, Revenue Bill of 1951, p. 42.

[9] Reg. 118 § 39.117(j)-2. *Livestock held for draft, breeding, or dairy purposes.* (a) For the purpose of this section, the term "livestock" shall be given a broad, rather than a narrow, interpretation and includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. It does not include chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc.

(b) The determination whether or not livestock is held by the taxpayer for a draft, breeding, or dairy purpose depends upon all of the facts and circumstances in each particular case. The purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal. However, a draft, breeding, or dairy purpose may be present in a case where the animal is disposed of within a reasonable time after its intended use for such purpose is prevented by accident, disease, or other circumstance. An animal held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business may, depending upon the circumstances, be considered held for a draft, breeding, or dairy purpose. An animal is not held by the taxpayer for a draft, breeding, or dairy purpose merely because it is suitable for such purpose or because it is held by the taxpayer for sale to other persons for use by them for such purpose. Furthermore, an animal held by the taxpayer for other purposes is not considered to be held for a draft, breeding, or dairy purpose merely because of a negligible use of the animal for such purpose or because of the use

These Regulations of the Commissioner have been widely criticized for the narrowness of some of the language and examples used. It is feared that the Regulations will lead to an overly strict application of old Section 117(j) and the new Section 1231 by revenue agents in the field. When Regulations are promulgated under the 1954 Code they should be compared very carefully with the Regulations under the 1939 Code.

The difficulty faced by the Commissioner in formulating regulations for determining whether animals have been held by taxpayers for breeding purposes is that the criteria called for by the statutory language is a criteria of intent on the part of the taxpayer to so hold the animals. For obvious reasons, the Commissioner is not content to rely upon the statement of the taxpayer as to the nature of the taxpayer's intent. Therefore, the Commissioner seeks to establish some objective standards for determining the taxpayer's intent. The Commissioner recognized in his Regulations 118, 39.117(j)-2 that the intent of the taxpayer is to be determined upon a consideration of "all of the facts and circumstances in each particular case," but "the purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal." In actual application of the Regulations the word "ordinarily" generally seems to be ignored by agents in the field, and the standards previously applied under the old rulings are still important. Taxpayers who can show that certain sales diminished the herd and were occasioned by unusual circumstances such as drought and disease will easily satisfy revenue agents. So also will taxpayers showing substantial use for breeding purposes of animals sold, as having produced several offspring or, in the case of animals which litter, having produced several litters. These are the circumstances

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of the animal for such purpose as an ordinary or necessary incident to the purpose for which the animal is held.

(c) These principles may be illustrated by the following examples:

EXAMPLE (1). An animal intended by the taxpayer for use by him for breeding purposes is discovered to be sterile, and is disposed of within a reasonable time thereafter. This animal was held for breeding purposes.

EXAMPLE (2). The taxpayer retires from the breeding or dairy business and sells his entire herd, including young animals which would have been used by him for breeding or dairy purposes if he had remained in business. These young animals were held for breeding or dairy purposes.

EXAMPLE (3). A taxpayer in the business of raising hogs for slaughter customarily breeds sows to obtain a single litter to be raised by him for sale, and sells these brood sows after obtaining the litter. Even though these brood sows are held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business, they are considered to be held for breeding purposes.

EXAMPLE (4). A taxpayer in the business of raising horses for sale to others for use by them as draft horses uses such horses for draft purposes on his own farm in order to train them. This use is an ordinary or necessary incident to the purpose of selling such animals, and, accordingly, these horses are not held for draft purposes.

EXAMPLE (5). The taxpayer is in the business of raising registered cattle for sale to others for use by them as breeding cattle. It is the business practice for the cattle to be bred, prior to sale, in order to establish their fitness for sale as registered breeding cattle. In such case, those cattle used by the taxpayer to produce calves which calves are added to the taxpayer's herd (whether or not the breeding herd) are considered to be held for breeding purposes; the breeding of other cattle is an ordinary or necessary incident to the holding of such other cattle for the purpose of selling them as registered breeding cattle, and the breeding of such cattle does not demonstrate that the taxpayer is holding the cattle for breeding purposes.

EXAMPLE (6). A taxpayer, engaged in the business of buying cattle and fattening them for slaughter, purchased cows with calf. The calves were born while the cows were held by the taxpayer. These cows were not held for breeding purposes.

which agents in the field will continue to look for as evidence of taxpayers having held animals for breeding purposes.

The Regulations cited above recognize that in some instances animals shall be considered as draft, breeding, or dairy animals, even though they are disposed of at an early date and have not reached the point of actual fulfillment of their intended use. But those Regulations provide that in such instances the intended use should have been prevented by "accident, disease or other circumstances." The words "other circumstances" can certainly cover a wide scope. It should cover the circumstance of the taxpayer desiring to eliminate animals which have not met the standard desired for his herd, but this is a point on which taxpayers will at least have to present convincing reasons concerning the undesirable characteristics of the animals in question. In this area the Commissioner is at a disadvantage, since the testimony of the taxpayer as to his intention can establish a prima facie case.

The author suggests that the general tone of Regulations 118 § 39.117(j)-2 is such that there will be an overemphasis in their application in the field on the *reasons for sale* of animals as a determining factor in ascertaining whether the capital gains provisions of old Section 117(j) and the new Section 1231 are to apply to the sale. Animals actually held by the taxpayer for draft, breeding, or dairy purposes should come within the scope of these sections regardless of the reasons for their sale. The circumstances under which the taxpayer sells his animals should be considered only as some evidence of his intentions to hold the animals as draft, breeding, or dairy animals. Greater emphasis should be placed upon the facts of how the animals are held rather than looking to indirect evidence such as the reasons for sale.

It is significant that generally the courts have looked upon the circumstances of sale of breeding animals as secondary evidence. The courts have considered as of primary importance the particular facts surrounding the operation of the herd prior to sale. In *Albright* v. *United States*[10] the court, upon a factual determination that the usual practice in the hog-raising industry was to dispose of sows after one litter, determined that the sows had been held for breeding purposes and not primarily for sale to customers. In *Fawn Lake Ranch Co.* v. *Commissioner*,[11] the court found a clear segregation of animals held for sale to customers and animals held for breeding purposes. The taxpayer maintained two accounts, one for the breeding herd and one for animals held for sale in the ordinary course of business. Until heifers were two years old, they were a part of the herd held for sale. At two years of age those heifers which appeared desirable for breeding purposes were transferred to the breeding herd. The court agreed that from the time of such transfer the animals were held for breeding purposes and were Section 117(j) assets when sold even though some animals had not produced offspring.

In the *Fox*[12] and *Laflin*[13] cases heifers were excluded from the classification of animals held for breeding purposes. In the *Fox* case the court found that the average age of calving was 24 months and then proceeded to use this average age as a practical measure in determining which animals qualified for capital gains treatment under Section 117(j). In the *Laflin* case the court found that heifers up to 22 months of age and young bulls had been regularly raised for sale for the reason that they were considered by the taxpayer as his annual cash crop. On the other hand, in *Miller* v. *United States,*[14] heifers regularly introduced into the breeding herd at 14 months qualified under Section 117(j) when sold at 18 or 19 months of age in the normal process of culling the breeder herd.

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[10] (8 Cir. 1949) 173 F. 2d 339, 37 AFTR 1125.

[11] 12 T.C. 1139 (1949).

[12] *Walter S. Fox*, 16 T.C. 854 (1951).

[13] *Laflin* v. *U.S.* (D.C., Neb., 1951), 100 F. Supp. 353, 41 AFTR 227.

While the decisions in these various cases may seem to be in conflict, a closer analysis indicates that the courts are generally in accord. What each court looked for was the intent of the taxpayer to hold the animal for breeding purposes and an actual holding of the animal for breeding purposes, but not necessarily an actual use for breeding purposes. Therefore, in each case the court examined the details of the particular breeding operation of the taxpayer to determine at what point a particular animal became dedicated to breeding purposes. For example, in the *Fawn Lake Ranch Company* case, heifers intended to be held for breeding purposes were taken from the feeder herd and placed in the breeding herd, and the court deemed this act of segregation and classification as evidencing the intent of the taxpayer to hold the animals for breeding purposes. In the *Fox* case where an age of 24 months was used for the time of division between cows held for sale to customers and those held for breeding purposes, and 34 months was set as a standard for young bulls, the court was doing the best it could under the circumstances to find some basis of distinguishing between animals held for sale to customers and animals held for breeding purposes, where the evidence presented by the taxpayer as reported in the published decisions failed to present the court with a more favorable indication of the taxpayer's intention. One of the big difficulties the taxpayer encountered in the *Fox* case was that his evidence tended to establish a program of holding animals for breeding purposes that would in a very short time cause the breeding herd to have as many bulls as cows.

In the recent case of *McDonald* v. *Commissioner,*[15] the Second Circuit gave a most liberal interpretation to the "held" for breeding purposes provision of Section 1231. The court found that the taxpayer held young animals for breeding purposes and culled them from the herd as soon as they developed undesirable characteristics. The *McDonald* case should not be looked upon as an exception to the principle stated above that all the facts of how the breeder herd is maintained are determinative of when animals are held for breeding purposes. There the taxpayer established to the satisfaction of the Circuit Court that his method of maintaining the breeder herd was to hold young animals as part of the breeder herd, culling out unfit animals as soon as unsatisfactory characteristics appeared. It seems unlikely that many taxpayers will be able to manage their herds in a manner suitable to establish such a holding of young animals as was accepted in the *McDonald* case, and other Circuits might not have interpreted the facts established by the lower court in the same manner as the Second Circuit.[16] The real significance of the *McDonald* case is that a Circuit Court has clearly stated that there are no clearly defined rules on what constitutes holding for breeding purposes and the actual practice of the taxpayer evidencing a holding for breeding purposes regardless of age is the ultimate fact in the application of Section 1231.

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[14] (D.C., Neb., 1951) 98 F. Supp. 948, 40 AFTR 1151.

[15] *McDonald* v. *Commissioner* (2 Cir. 1954), 214 F. 2d 341, 45 AFTR 1733.

[16] See *Gotfredson* v. *Commissioner* (6 Cir. 1954), 217 F. 2d 673; *Fox* v. *Commissioner* (4 Cir. 1952), 198 F. 2d 719, 42 AFTR 544. Cf. *Estate of C. A. Smith,* 23 T.C. 690 (No. 91) (1955), where age test was overcome by segregation between breeder herd and other animals.

Although primary consideration should be given to the details of how the breeder herd is maintained in determining what animals have been held for breeding purposes, secondary evidence such as the reasons for sale has been employed in some cases to support the fact of holding for breeding purposes by showing that the incident of sale was not a normal marketing operation. The recent case of *Deseret Live Stock Company*[17] illustrates this principle. In that case taxpayers' testimony to the effect that all female animals were retained for breeding purposes was given validity by the further testimony that substantial sales of heifer yearlings and two year olds in certain years were made necessary by droughts which lowered the capacity of the ranges to such an extent that the particular animals had to be sold.

Similarly, the Commissioner has been successful in using evidence of the reasons for sale to overcome taxpayers' contentions that animals were held for breeding purposes and not primarily for sale to customers. In the *Fox* and *Laflin* cases cited above the Commissioner convinced the courts that the reasons for sale year after year added up to the production of annual "money crops" which were held primarily for sale to customers. It made no difference that certain registered livestock had been bred before sale since that was a normal procedure in proving the suitability of the animals for use as breeders by the buyer. However, it should be kept in mind that the reasons for sale are always secondary in importance to the direct evidence of how the breeder herd is operated prior to sale of the animals in question. The reasons for sale are only some evidence of the intent of the taxpayer in holding the animals sold.

8. What Procedures in Livestock Operations Tend to Establish the Existence of the Elements Essential for Capital Gains Treatment?

In undertaking an investment in breeder livestock, the investor must of course begin with the acquisition of animals and facilities for their maintenance. The purchase price of animals must be capitalized. If the animals are held for breeding purposes, that original cost is depreciated. If the animals are held merely as feeders and later sold, their cost cannot be depreciated, but it will be the basis for computing income on sale of the animals. At the very beginning, the taxpayer should adopt as standard operating procedure clear records showing what animals are held for breeding purposes. For reasons previously discussed he should use the cash basis of accounting for income tax purposes.

In the normal course of operations, approximately half of the offspring of a breeder cattle herd will be males, most of which will be converted to steers, fattened, and sold, or will be sold as bull calves. Ordinary income will result from these sales. Only a few male animals will be retained for breeding purposes and thereby qualify as Section 1231 assets. Likewise, not all female animals are likely to be retained for breeding purposes, since some may not meet the standards set for inclusion in the breeder herd or economic forces may require the inclusion of some females in the feeder herd. Therefore, it becomes desirable to establish standard operating procedures for the handling of both the male and the female offspring of the breeder herd. For example, after weaning, heifers normally may be segregated from the breeder herd. At an appropiate time these heifers will be graded and those selected by the stockman for breeding purposes will be returned to the breeder herd. There is a wide range of practice as to the age at which a heifer is returned to the breeding herd. If heifers are placed in the breeding herd at a relatively young age, the reasons for such an early dedication to breeding purposes should be carefully preserved in the event some of these animals are sold from the breeding herd at an early age without having produced offspring.

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[17] Par. 53,093 Prentice-Hall Memorandum T.C. (1953)

Where an animal has been used in the breeder herd for a substantial period of time and has produced a number of offspring, there is no doubt about the animal qualifying as a Section 1231 asset. It makes no difference that the animal, before sale, is turned into a feed lot for fattening and otherwise handled in a manner conducive to obtaining the best price on sale. Over the years, animals in this category should constitute a substantial part of all animals sold as Section 1231 assets in a normal operation. The investor who has a clear and consistent practice of retaining animals for substantial use in the breeding herd will have no difficulty establishing capital gains treatment for the proceeds of sale of such animals.

The area in which the stockman will continue to encounter great difficulty is in the sale of unbred animals or animals which may have been bred merely for the purpose of proving them as animals suitable to be sold to buyers for future use as breeder animals. To show that the particular animals sold had been held for breeding purposes, the taxpayer should be prepared with records of the history of individual animals to show when and how they were dedicated to breeding purposes. The taxpayer's records should also show the nature of his complete operations as a means of establishing a well defined breeding routine clearly distinguishable from that part of his business involving animals held primarily for sale to customers.

Where the taxpayer has realistically segregated his young animals to be used for breeding purposes from those to be sold to customers in the ordinary course of business, he has done all that is necessary to qualify those animals held for breeding purposes as Section 1231 assets when they have been held for more than one year. The catchword in this last sentence is the word "realistically." It is not realistic to set aside as many young bulls as heifers for the breeding herd in a cattle breeding operation. Realism also calls for an appropriate segregation of those animals to be held for breeding purposes from breeder animals which are held by the taxpayer primarily for sale to customers for use as breeders. Where a taxpayer claims that proceeds of sale of young animals are subject to capital gains treatment, the taxpayer will find it to his advantage to have maintained a record of the precise reasons for sale of these young animals as additional evidence of his having held them for breeding purposes and not primarily for sale to customers. Some reasons for sale which may be helpful are the fact of drought or disease making liquidation of animals necessary. Also, unusual financial necessity on the part of the taxpayer could be a factor, as can the failure of the animals being sold to come up to the standards originally anticipated of them at the time of their dedication to the breeding herd.

In the final analysis, the true intent of the taxpayer to hold certain animals for breeding purposes must be arrived at by an examination of all the aspects of the livestock operation. Records of that operation are of obvious value as proof. But records only evidence the procedures by which the taxpayer has assembled, increased, and sold his animals. Those animals clearly held for breeding purposes will qualify as Section 1231 assets, but taxpayers who repeatedly attempt to qualify young animals as Section 1231 assets will encounter great difficulties.

9. In What Kind of Livestock Operations Are There Tax Dangers?

a. Short-term speculation. In recent years there has been a tremendous influx of investors into the cattle business and other livestock businesses who have had no previous agricultural experience. They range from those who invest in a few head of cattle to be raised at their country homes, to the large investors who purchase a complete ranch operation retaining professional cattlemen to manage their investment. There has even been some buying of animals from ranching companies which advertise special management arrangements for the small investor who has no facilities. The purchaser may leave the purchased animals in the hands of the seller for raising and breeding on a fixed schedule of boarding and breeding fees. The purchasers are offered such inducements as being able to visit the ranch on weekends and help care for their animals. In the sales promotion of these businesses there is often the implication that capital gains are available by mere compliance with the statutory one-year holding period and some not too clearly defined program of breeding the purchased animals.

Some of these taxpayers are bound to run into difficulty as hobby farmers, a subject discussed below. A larger number of them will find that they have engaged in short-term speculation with no intent to hold animals for breeding purposes. It must be kept in mind that if there is no actual holding of animals for breeding purposes then the one-year holding period is no protection. The distinction is apparent between (1) an investor who purchases a small herd of reasonably high grade animals with the intention of holding that herd for several years and building it up both in quantity and quality, selling during the interim those animals which are not desired for breeding purposes, and ultimately disposing of the herd as a capital asset; and (2) a short-term speculator who seeks to get in and out of the business in such a short period of time as to evidence no true intention of being in the business of breeding livestock. In operations of the second type capital gains treatment of the proceeds of sale is at least speculative.

b. Operations in which there is not a proper segregation of breeder and feeder animals. Where feeder and breeder animals are not clearly identifiable, there is always the possibility that the taxpayer will not be able to meet his burden of proof as to the correctness of his claim that the particular animals sold were animals which had been held for breeding purposes. This becomes primarily a question of adequate records, as has been discussed in Paragraph 8 above. Beyond this question of improper segregation of breeder and feeder animals is the situation where a breeding phase is added to what is actually a feeder operation. An example of this is where feeder cattle are run through a breeder herd in an attempt to achieve capital gains treatment on the sale of all animals which have produced offspring and which have met the statutory one-year holding period requirement. Such practices are not acceptable to the Bureau of Internal Revenue. It is probable that in most situations of this nature the courts would support the contention of the Commissioner that ordinary income has been realized from the sale of animals held primarily for sale to customers, breeding having been a mere incident to such holding.

c. Hobby ranching. A hobby rancher or farmer is one who engages in the particular activity in which he is interested for recreational purposes and not for profit. A great deal has been written and the Regulations under the 1939 Code are clear on the subject of not permitting losses from such operations to be offset against income from other sources.[18] From the point of view of achieving capital gains on the sale of draft, dairy, and breeder animals, the hobby farmer has still another problem. The purpose of Section 1231 is to allow capital gains treatment on certain items used by a taxpayer in his trade or business. If the particular activity of the taxpayer is a hobby and not a trade or business, capital gains treatment is not available.

10. Conclusion

It is hoped that the foregoing analysis of how capital gains are achieved in breeder livestock operations will not mislead readers into looking upon Section 1231, as it pertains to livestock, as a tax loophole. Section 1231 is applicable to certain assets in almost every business. But more than this, the legislative policy considerations behind Section 1231 are particularly applicable to the livestock industry, in which there exist hazards not usually encountered elsewhere. The fact that greater capital gains are available to stockmen who invest in breeding herds than to some investors in less hazardous ventures does not thwart Congressional intent. Finally, the market for any kind of property is the ultimate leveling influence. Without capital gains treatment of some of the proceeds of their sales in the past two or three years, many cattlemen would not have been able to continue in business. Therefore, the would-be investor in livestock should consider possible tax advantage only as one aspect of a complicated undertaking.

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Unharvested Crops

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The sale of unharvested crops can be approached from the standpoint of the seller and of the buyer. Such crops can also be sold apart from the land or together with the land, and receive different tax treatment in each case.

So far as the seller is concerned, the problems formerly involved in the sale of unmatured crops with the land have been substantially eliminated by Section 323(b)(1) of the Revenue Act of 1951. This amendment added Section 117(j)(3) to the Internal Revenue Code (Section 1231(b)(4) in the 1954 Code) and permits capital gain treatment of unharvested crops sold with the land.

Although the term "Section 117(j)" has come to have a widely known and widely understood meaning in itself, the 1954 Code changes the section number to Section 1231 and the new number will be used in the balance of this chapter.

1. Points to Consider

Problems regarding sales or purchases of unharvested crops are discussed below in the following order:

Section

How the seller treats sales of unharvested crops sold with the land 2
  (a) When the capital gain privilege applies .... 2(a)
  (b) What to do when compulsory or involuntary conversions are involved .... 2(b)
  (c) How production costs of crops must be treated .... 2(c)
How the seller treats sales of unharvested crops sold with the land for years prior to 1951 3
How the seller treats sales of unharvested crops sold apart from the land or under conditions not complying with Section 1231(b)(4) (1939 IRC 117(j)(3)) 4
How to allocate the price between land and unharvested crop 5
How the buyer treats purchases of unharvested crops bought with the land 6
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Tax Saving Suggestions to the Seller 8
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2. Seller's Treatment When Crops are Sold with the Land

a. When the capital gains privilege applies. The privilege of treating sales of growing crops, unripe fruit, etc. as long term capital gains (50 per cent of the gain subject to tax) applies where the land and crop are sold together under the following conditions:

1. The land must be held for more than 6 months.[1]
2. The land must be used in the taxpayer's trade or business.[2]
3. Crop and land must be sold or exchanged at the same time.[3]
4. Crop and land must be sold or exchanged to the same person.[4]
5. The transaction must occur in a calendar year or fiscal year beginning after December 31, 1950.[5]
6. No right or option to reacquire the land directly or indirectly may be retained by the taxpayer (except one customarily incident to a mortgage or other security contract).[6]
7. Gains from such sales or exchanges plus recognized[7] gains on other Section 1231 sales, exchanges or conversions, or involuntary conversions of capital assets must exceed recognized losses on other Section 1231 sales, exchanges or conversions and involuntary conversions of capital assets.[8]

Compulsory or involuntary conversions of unharvested crops are within the provisions of the statute as well as sales and exchanges.[9] It is not necessary that the crop itself be held for any specified period[10] or that it reach any particular state of maturity.

While the above enumeration of the tests of applicability of the capital gains provisions makes a formidable appearing list, it is only in rare and unusual circumstances that the seller will fail to qualify. It will be quite infrequent, for example, that immature crops and the land are sold to different persons, or at different times, or that the land was owned six months or less by the seller. The slightest amount of preliminary planning will bring the seller within the favored provisions in most instances.

The first condition listed, namely that the land must be held for more than six months, is easily complied with. It is simply a matter of making sure more than six months has passed since the date of acquisition before the selling transaction takes place. However, a leasehold interest or term for years is not "land" for the purpose of the section relating to sale of unharvested crops.[11]

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[1] 1954 IRC § 1231(b)(4); 1939 IRC § 117(j)(3) reads as follows: "SALE OF LAND WITH UNHARVESTED CROP. In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as 'property used in the trade or business.'"

[2] Id.

[3] Id.

[4] Id.

[5] Revenue Act of 1951 § 323(b)(1).

[6] Reg. 118 § 39.117(j)-1(d).

[7] Gains on some involuntary conversions of property are not recognized. See 1954 IRC § 1033; 1939 IRC § 112(f).

[8] 1954 IRC § 1231(a); 1939 IRC § 117(j)(2). If a net loss results it is not treated as a capital loss but as an ordinary loss.

[9] 1954 IRC § 1231(b)(4); 1939 IRC § 117(j)(3). But see § 2(b) below concerning uncertainties regarding involuntary conversions.

[10] Reg. 118 § 39.117(j)-1(d).

As to the second requirement listed above, land is "used in the trade or business" when there is the slightest amount of activity such as renting the land.[12] Probably ownership *alone* would not qualify one as being in a trade or business but anything beyond merely holding title as an investment probably qualifies the owner. Certainly the raising of a crop which requires any sort of activity in planting, cultivating, spraying, or caring for it, would constitute a trade or business of the owner whether performed by the owner, his family, his employee, or tenants. A taxpayer may engage in many trades and businesses and it is not at all necessary that raising of crops or the renting of land on whicr crops are raised be his principal business in order to qualify for capital gains treatment of the sale.

The third, fourth, and fifth of the qualifications listed are self defining and self explanatory. It is seldom that sales of unharvested crops and land would be made to different persons or at different times under ordinary circumstances, but certainly it will pay the seller to make sure that his sale meets these easily met requirements. Automatically, any such sales made in tax or calendar years beginning after December 31, 1950, will comply with the statute.

Nothing in the statute forbids the seller from retaining an option to reacquire the land, but this prohibition is made by the regulations.[13] The seller may not keep a "right or option to reacquire the land directly or indirectly except such rights as are customarily incident to a mortgage or other security contact." [14]

The general provision for adding all Section 1231 gains and losses must be followed.[15] A farmer or other owner selling his land and, for example, a growing corn crop, would have to add gains and losses on other transactions involving Section 1231 items such as (1) timber (under certain conditions) (2) coal, (3) other land, (4) his business automobile, (5) machinery and equipment used in the business, and (6) brood sows, dairy cows, and other draft, dairy, or breeding animals held for 12 months or more. He would also have to consider these together with involuntary conversions of "capital assets" owned over 6 months.[16] Capital assets which when involuntarily converted must be included might be (1) the taxpayer's residence, (2) his automobile reserved for personal uses, and (3) household goods.

Gains or losses on "capital assets" which are sold or exchanged in the same year, are not figured into the total for the purpose of applying the Section 1231 test, but these gains or losses will be figured in before final computation of the tax.[17]

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[11] Id.

[12] *Leland Hazard*, 7 T.C. 372; *Reiner* v. *U.S.*, 222 F. 2d 770 (1955). But *Grier* v. *U.S.*, 120 F. Supp. 395 (1954), affirmed, 218 F. 2d 603 (2 Cir. 1955) held that a loss on the sale of a single rented residence was a capital loss, not in a trade or business. Accord: *Emery*, 17 T.C. 308 (1951).

[13] Reg. 118 § 39.117(j)-1(d).

[14] Id.

[15] 1954 IRC § 1231(a); 1939 IRC § 117(j)(2).

[16] Id.

[17] *John L. Sullivan*, 17 T.C. 1470; 1954 § IRC 1231; 1939 § 117(b).

If the seller fails to bring his sale of unharvested crops within the provisions of the section, he has ordinary income from the sale and has a problem of allocating a portion of the sales price to the land and a portion to the crop, as is discussed more fully below.[18]

b. What to do when compulsory or involuntary conversions are involved. While the statute refers to "involuntary conversions" along with sales and exchanges, only one kind of involuntary conversion can be said with certainty to be covered by Section 1231(b)(4) of the 1954 Code. A condemnation or seizure type of conversion is the only type of conversion which could involve crop and land "at the same time or to the same person."

As to other forms of compulsory or involuntary conversion, such as theft or the destruction of a growing crop by hail or windstorm, it is very doubtful that proceeds can receive capital gain treatment. The difficulty lies in finding any applicable meaning of the law with reference to such forms of involuntary conversion.

It is clear, so far as sales and exchanges are concerned, that the sale or exchange of crop and land must be at the same time and to the same person. Compulsory or involuntary conversions seem to be in the same class as one reads the statute.[19] However, it is obvious that destruction or theft of a crop cannot come at the same time and involve the same person as the one to whom the land is sold. A taxpayer could scarcely rush to town the same day a hail storm destroyed his crop and arrange to sell his land to the insurance company. Even if he could, the sale would hardly qualify as being "at the same time." Consequently it might be reasonable to conclude that the words "(or compulsory or involuntarily converted)" being parenthetically enclosed, do not necessarily relate to the words "at the same time and to the same person." Certainly it is true that these words add very little to the statute if the conversion of the crop and conversion or sale of the land must coincide as to time and person.

The Senate Committee which added the section to the Internal Revenue Code had no comment to make upon the intended effect of the provisions relating to involuntary conversions.[20] The taxpayer having the issue involved should take the position that the phrase would not have been enclosed in parenthesis if the law makers had intended to have involuntary conversions considered entirely in the same class as sales and exchanges.

c. How production costs of crops must be treated. A seller taking advantage of Section 1231(b)(4) must thereafter treat his expenses of producing the crop as a capital investment. These expenses "whether expenses, depreciation or otherwise" are simply adjustments of the basis of the property for the purpose of determining gain or loss on the sale.[21] The normal procedure of deducting the costs of raising a crop from the gross income is not permitted where the seller takes advantage of the capital gains treatment.[22]

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[18] See Section 5 of this Chapter.

[19] 1954 IRC 1231(b)(4); 1939 IRC § 117(j)(3).

[20] Report on Revenue Act of 1951 Senate Committee on Finance.

[21] 1954 IRC § 1016(a)(12); 1939 IRC § 113(b)(1)(L).

[22] 1954 IRC § 268; 1939 IRC § 24(f).

The deduction of expenses as an offset against ordinary income is disallowed even though paid or incurred in a tax year other than the one of sale, exchange or involuntary conversion.[23] In such case, a recomputation in the form of an amended return should be made if necessary.[24] Thus a cash basis farmer who deducts the costs of raising a crop in one year's return and sells the land and crop the following year, should file an amended return in which costs attributable to raising the crop are not claimed. Even the depreciation on the machinery used in producing the crop would seem to be disallowed as a deduction in the first year and added to the basis for the purpose of computing gain in the year of sale. Only in an instance where the year involved is closed to further treasury action would there seem to be the prospect of omitting the amended return.

3. Seller's Treatment of Sales With the Land—Years Prior to 1951

For years not affected by the new law (namely calendar years prior to 1951 and all fiscal tax years which did not begin after December 31, 1950) the Bureau's position has been that the price received must be allocated between the land and the unharvested crop, with the part allocated to the crop to be treated as ordinary income.[25] The Bureau was fully vindicated in this position by the United States Supreme Court on May 19, 1953.[26] Consequently, for tax years not eligible under Section 1231(b)(4), the seller must report as fully taxable the proceeds attributable to the unharvested or unpicked crop. In turn, he may deduct in full his expenses of raising the crop.

The *Watson* case came before the Supreme Court on a writ of certiorari from a decision favorable to the Commissioner in the 9th Circuit. The Supreme Court held that with reference to the sale of an orange grove with unpicked fruit on the trees, the part of the price attributable to the crop was not subject to capital gain treatment. The fact that under state law the unharvested crop was a part of the land, was held immaterial on the question of the application of the Federal Income tax. The court accorded great importance to the interpretation of the prior law as evidenced by the committee report and the changes they considered necessary. The decision directly sustained the Commissioner's position that proceeds fairly attributable to the crop were derived from property "held by the taxpayer primarily for sale to customers in the ordinary course of business." [27]

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[23] Reg. 118 § 39.24(f)-1.

[24] Id.

[25] I.T. 3815, 1946-2 C.B. 30.

[26] *Watson* v. *Commissioner* 73 S. Ct. 848 (1953).

[27] Justices Minton, Reed, and Douglas dissented to the decision and to the writer seem to have the sounder side of the argument. On the primary question as to whether green oranges on the tree "are held primarily for sale in the ordinary course of business," even the Supreme Court's holding that they are so held, doubtless leaves the fruit grower unconvinced. He knows that unripe fruit has a very limited market and that his primary purpose of keeping unripe fruit is to bring it to a state of maturity. Only at that stage does it become marketable and at that point the owner begins to hold it for sale. The Watson decision is like telling the hog farmer that he keeps young pigs primarily to sell whereas his primary purpose is to feed them out to a weight where they will sell as market hogs. As was pointed out by Mr. J. A. Formella in a law review article (footnote 26 below) the statute referred to property "held for sale" not "held to be sold." The Supreme Court has in effect made "held for sale" and "held to be sold"

Prior to the Supreme Court decision there was a definite conflict of authority and opinion. Two U.S. Circuit Courts and two U.S. district courts had sided with the taxpayer holding that unharvested crops being attached to the land were a part thereof and entitled to Section 1231(b)(4) treatment.[28] Writers of two law review articles preferred the same side of the argument.[29] The Tax Court, the 9th Circuit and one law review writer took the position advanced by the Bureau.[30]

4. Seller's Treatment of Sales Apart from the Land or Otherwise Not Complying with Section 1231(b)(4)

Where growing crops are sold apart from the land the seller obviously has ordinary income to the extent of the sale price of the crops and deducts all the ordinary and necessary expenses of producing the crop from his taxable income. No problems of allocation are involved and there is no possibility of getting the capital gains treatment.

Normally the same will be true of a sale involving crops and land together, if the sale fails in other respects to meet requirements of Section 1231(b)(4), since if the land and crops are not sold at the same time, or are sold to different parties, it will almost certainly mean that buyer and seller have agreed upon a price for the crops alone. The allocation will normally be made by the parties themselves and the income from the crop will be treated in the same manner as where the crops are harvested and sold.

However, it is conceivable that some situations might involve the seller in an allocation problem like that involved in sales of crop and land before 1951. If the taxpayer is the buyer, he will invariably have the allocation problem. He must arrive at the fair market value of the crop on the date of sale unless the parties had agreed on a price for the crop.[31]

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mean the same thing.

Another aspect of the decision which invites criticism is the reliance placed by the court upon the interpretation of a prior statute by members of a Congressional Committee. It must be conceded that the meanings intended by the legislative members of a committee with reference to an act they are writing, should be given every consideration by the courts, but why should their conclusion be considered reliable as to the meaning of prior enactments? Most of us can bring to mind certain Committee Chairmen whose interpretations of statutes they seek to change might often be far from accurate. It seems a risky precedent to be guided by the opinions of a few committee members as to a law which others drafted. The meaning of a statute should be determined from the words actually used and the intentions expressed by those who drafted the law, not by those who may be advocating a change.

[28] *McCoy* v. *Commissioner* (10 Cir. 1951) 192 F. 2d 486, reversing 15 T.C. 828 (Kansas); *Owen* v. *Commissioner* (5 Cir. 1951) 192 F. 2d 1006, reversing, 50,300 Prentice-Hall Memorandum T.C. (Florida); *Irrgang* v. *Fahs* (D.C. Fla. 1950) 94 F. Supp. 206, 39 AFTR 1376; and *Cole* v. *Smyth* (D.C. Calif. 1951) 96 F. Supp. 275, 40 AFTR 522.

[29] J. A. Formella, "Disposition of Gain Realized from Sale of Land with Growing Crop," Marquette Law Review, Summer 1951, Vol. 35, page 50 and J. P. Hill, "Ordinary Income or Capital Gain on Sale of Orange Grove," *Miami Law Quarterly*, Fall 1950, Vol. 4, pages 145-153.

[30] *Watson* v. *Commissioner* (footnote 23, above) which affirmed 197 F. 2d 56, 41 AFTR 1372 which in turn had affirmed 15 T.C. 800; Estate of Henry L. Miller, 51,064 Prentice-Hall Memorandum T.C.; Mason P. Thomas, Jr., "Gain from Sale of Land with Growing Crops," No. *Carolina Law Review*, Fall 1950, Vol. 29, pages 326-328.

[31] O.D. 714, 1920 3 C.B. 49. The effect of an agreement between the parties in fixing the value of crops is discussed in greater detail in Section 9 of this chapter.

5. How to Allocate the Price Between Land and Unharvested Crop

In making an allocation between land and crop there are many factors of importance besides the ultimate market value of the crop after it is harvested. Obviously the possibility of storm, frost, blight, insect infestation or other hazards between the time of sale and the maturity of the crop, have a vital bearing on the fair market value of the crop on the date of sale. The cost of bringing the crop to maturity, harvesting costs, and the question of which party is to stand these costs, also are of evident importance in fixing a value on the immature crop.

The valuations on growing crops which the Commissioner has attempted to fix upon taxpayers have varied widely from that fixed by the courts. In *Watson* v. *Commissioner*[32] the Supreme Court approved the Tax Court's allocation of $40,000 to the orange crop, whereas the Commissioner had allocated $122,500 to the crop.[33] In *Marian L. Bloxom, et al.*[34] a buyer sought to allocate $16,800 to the crop he purchased while the Commissioner attempted to limit the amount to what the seller had spent on the crop or $3257.97. Without explaining, the Tax Court set the value at $11,000.

Facts in each case will differ from every other, but with some of the factors outlined above in mind, the practitioner must arrive at his best estimate of the fair market value on the date of sale, unless the parties fixed a price at the time of sale.

6. How the Buyer Treats Purchases of Unharvested Crops Bought With the Land

The purchaser who buys immature crops with the land has the same problem of allocation, in every case, as that of the seller who does not come within the requirements of Section 1231(b)(4). His cost basis is the fair market value at the time of purchase in the absence of an allocation made in the contract between the parties.[35]

For the purpose of computing gain on the sale by a purchaser, the Tax Court held that "such portion of the lump sum payment properly attributable to the fruit on the trees at the time of the purchase of a citrus grove represented the cost of the matured fruit." [36]

The same factors as are discussed in Section 5 of this chapter bear upon the proportion of the total purchase price allocable to the crop. Having arrived at his allocation of the cost of the purchased crop, it is an offset against income he reports from sales or inventory of the crops at the end of his tax year. In other words the difference between cost of the crop and the price he gets will be ordinary income.

The importance to the buyer of the parties' fixing a price on the crop in their contract is discussed below in Section 9 of this chapter.

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[32] Footnote 26 above.

[33] The facts were that the land, trees, and unmatured crop sold for $197,000. When the crop was harvested, the approximately 74,000 boxes of oranges sold for $146,000 and netted about $126,000. The Commissioner contended that $122,500 should be allocated to the crop.

[34] *Marian L. Bloxom, et al.*, par. 52,079 Prentice-Hall Memorandum T.C. (1952).

[35] Footnote 31 above.

[36] *Triple E. Development Co.*, 20 T.C. 619 (1953).

7. How the Buyer Treats Purchases of Unharvested Crops Bought Apart From the Land

There seems only one possibility involving the sale or purchase of unharvested crops which is not treated above. This involves the purchaser's treatment of unharvested crops bought apart from the land. Obviously, such a purchaser has a cost basis when the price is set and this represents his basis for computing his ordinary gain or loss at the time the crops are sold. No problems of allocation are involved. The only possibility of capital gains treatment on the sale of the crop would be by later acquiring the land and selling both the land and the crop before it is harvested, after owning the land more than six months.

8. Tax and Trouble Saving Suggestions to the Seller

Since a sale of land with growing crop can usually be brought within Section 1231(b)(4) and therefore treated as a Section 1231 sale, it is desirable where possible that the taxpayer look ahead to the possible gains and losses on other items which must be treated in the same category.[37] It is normally a tax advantage to lump the loss items from such sales into one tax year (so that the loss is 100 per cent deductible) rather than have losses on some Section 1231 items offset other Section 1231 gains. If all sales occur during the same tax year, the effect is to cut down the amount of income which gets the long term capital gain treatment. Consequently, where the taxpayer sells land and crop in one tax year at a gain he might seek to defer sales of other Section 1231 items which are likely to result in a loss, until the following tax year. In some cases he might be able to plan such loss sales in the preceding tax year.

However, in seeking to plan tax savings in the above manner it should be kept in mind that in the year of selling land and crop the taxpayer will be apt to have a disproportionately high income. This may make it desirable to get as many loss items in the same tax year as possible. Otherwise the distorted income for the year of sale might put the seller into an unusually high tax bracket, whereas the loss items which could be switched to another year might bring little or no tax benefit in a year when taxpayer no longer has income from the land.

The seller who foresees the likelihood of the sale of land and crop in the next tax year will do well to prepare his current year's tax return accordingly. He should eliminate any costs of raising the crop to be sold next year which would normally be deducted in the current year's return. This will save the trouble and expense of filing an amended return later and leave the taxpayer free to add his production costs to the basis of the land and crop in the year of sale.

9. Tax Saving Suggestion to the Purchaser

In spite of a recent decision to the effect that the contract prices fixed by the parties do not necessarily control as to taxes,[38] it remains unquestionably desirable, from the purchaser's standpoint, that the sale price of growing crops be specified by the parties in their agreement. This is true because the purchaser usually derives ordinary income from the sale of the crop and the higher price the parties reasonably place upon the cost basis of the crop the less his margin of profit will be.

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[37] Items which must normally be considered are referred to in Section 2 of this Chapter, above.

[38] *Guilio Particelli, et al*, 212 F. 2d 498 (1954) affirming par. 52,044 Prentice-Hall Memorandum T.C.

Since 1920 the Treasury Department had recognized the right of the parties to make their own allocations[39] and it was held in a 1925 U.S. District Court case that a party had a right to establish any value he wished on items of property he has to sell.[40] Consequently, notwithstanding the *Particelli* case it will still be helpful to have the parties fix the allocations in the contract as they are not likely to be disturbed unless clearly unreasonable.

In the *Particelli* case, the court fixed the value of wine conveyed with a winery at $275,000, although the parties themselves placed a price of $77,000 on the wine, which was the O.P.A. ceiling price, and $273,000 on the winery (actually worth about $60,000). The court held in effect that an arm's length transaction without a ceiling price limit involved was necessary before the prices fixed by the parties are controlling. It was conceded that the total contract price was an arm's length transaction but the court did not consider the allocation as to prices of the wine and the winery to be the real agreement of the parties. The price paid for the wine of $275,000 was fixed at $1.00 per gallon for tax purposes by the court, which is the price the purchaser was willing to pay had it not been for the price ceiling.

It is conceivable that in following the *Particelli* case the courts may consider all sales of growing crops with the land as not "arm's length transactions" as to the price of the crop, since under the present tax law the seller has no interest in what allocation is made. However, it would seem to strengthen the buyer's position if the parties will place a not unreasonable price on the crops sold.

Parties in such a transaction often have to make a three-way allocation: (1) to the immature crops, (2) to trees or vines, and (3) to the land. Costs allocated to the crop hold out the greatest possibility of tax benefit to the purchaser for two reasons (1) the greater certainty of sale (2) the cost is an offset against ordinary gain instead of capital gain.

As to the cost allocated to trees and vines, a portion of that cost would become immediately available as a deduction from income in the form of yearly depreciation. If the property is owned by the taxpayer for the full useful life of the trees or vines, he could then recover the full cost. Consequently, assuming tax rates remain as high or higher, income remains as high or higher, and tax exemptions are not lowered, he would eventually recover his costs allocated to trees and vines to the same extent as the costs allotted to crops. However, one can scarcely plan his affairs that far ahead and in event the property is sold by the purchaser, it is obvious that his tax benefit from allocating costs to trees and vines will, if he makes a profit, be only one-half as great as compared with costs placed on the crop. Normally the sale would be treated as a capital gain and subject to the tax limitations on such gains, so that for most taxpayers they will want to seek to minimize the costs allotted to trees and vines as compared with costs placed on crops.

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[39] O.D. 714, 1920 3 C.B. 49.

[40] *Frazer* v. *Nauts* (D.C. Ohio 1925) 8 F. 2d 106, 5 AFTR 5600.

The facts involved the sale of an entire lumber business by the taxpayer's decedent. The buyer Willys-Overland Co. wanted lumber primarily. It also wanted storage space but did not care about buying good-will. However, good-will had a basis of $102,000 to the seller and parties in the contract fixed the sale prices as $100,000 for good-will, $250,000 for lumber, and $17,500 annual rental for 10 years for yards and shipping space. The government sought to allocate $350,000 to lumber and nothing to good-will. The court at one point said: "Hubbard had a clear legal right to fix a value on each item of property he had to sell, whether his choice was to establish a depreciated or exorbitant figure. He was justified in law to place upon his merchandise a low or inadequate price as an inducement to obtain a market for his less salable good-will."

It is even less desirable for the purchaser to place a high valuation on the land itself. As to the land there is no opportunity to recoup the cost through depreciation, and unless the land is later sold the purchaser derives no tax advantage whatever from that part of the cost which is allocated to the land. Since many buyers of such properties intend to remain owners until they die, they should seek to keep the amount of purchase price allocated to the land at the lowest reasonable level. As indicated above there is usually no conflict of interest between seller and purchaser as to allocations of price in a transaction of this kind because the seller will qualify for capital gains treatment on the whole transaction. The seller in such cases has nothing to gain or lose by variations in the amount properly allocated to trees and vines.

The purchaser should keep in mind the possibility that his purchase of land and crop might on resale be entitled to capital gain treatment, if he in turn can manage to comply with Section 1231(b)(4). Obviously a buyer who found soon after his purchase that circumstances would require or make desirable a resale of the land in the near future, would ordinarily be foolish to harvest the crop, derive ordinary income therefrom and then sell the land in a separate transaction. He could get capital gains treatment for any gains involved in the transaction by selling the land and unharvested crop together. On the other hand, should the market value of the crops at harvest time go below the price paid for the crop before maturity, the procedure of harvesting the crop and taking the loss thereon might have advantages over a sale complying with Section 1231(b)(4).

10. A Suggestion Applicable to Both Seller and Buyer

It is not impossible that both taxpayers in a transaction convert what would usually be ordinary income (sale of a crop) into capital gain income. Nothing in the law prevents a buyer of land and crop from becoming a seller of land and crop and if the nature of the crop is such that a more than six months period can intervene, the buyer could also bring himself within the provisions of Section 1231(b)(4) upon resale.

The purchaser of an orange grove soon after blossom time, might while the crop or part of it is still not matured, resell the land and crop back to the original owner or some other party. It seems the Bureau had that possibility in mind when it issued regulations forbidding the seller from having any option or right to repurchase.[41] Any pre-planned transaction involving resale to the original seller or a close relative, would be sure to run afoul of tax auditors. However, it may well involve a perfectly legitimate business transaction that the buyer elects to sell even though the sale be to the former owner.

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[41] Reg. 118 § 39.117(j)-1(d).

In the *Watson* case it seems an important factor in the seller's decision to sell was a belief that frost much later in the year was going to destroy the crop.[42] After the buyer had carried the risk of loss right up to harvest time, the original seller might have been willing to pay nearly market value for the crop and get back his orange grove and land. Had they done so in a year when the new law applied, the result would have been that the original seller could have treated $40,000 (the amount allocated to the crop) as capital gain and have the benefit of the alternative tax, if applicable, whereas the buyer would have had an additional $86,000 of ordinary income converted into capital gain by reselling land and crop. Between them they would have saved the tax on $63,000 (one-half the net proceeds of the crop) plus any additional benefits they might have by reason of the alternative tax on capital gains. In other respects they would have ended the year in the same position they started.

Obviously, a series of such transactions would soon put the taxpayer into a classification as a dealer in lands and crops, but it is difficult to find any legitimate objection to such a transaction when entered into without prearrangement in an isolated instance.

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[42] Footnote 26, above.

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Sales of Patents and Copyrights

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Copyrights and patents are the legal devices by which Congress has chosen to exercise its power "to promote the progress of science and the useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries."[1] That such exclusive rights are property is emphasized by the insertion in the Patent Act of 1952, recasting the patent laws, of the statement that "subject to the provisions of this title [35 U.S.C.], patents shall have the attributes of personal property."[2] By constitutional requirement ["securing . . . for limited times"] such property is exhaustible or "wasting."

1. Points to Consider

The principal question of tax interest in connection with sales of patents and copyrights is whether the proceeds may be eligible for the tax treatment accorded long-term capital gains instead of ordinary income taxation. Another important tax consideration is how the purchaser may charge off allowances for exhaustion (depreciation) against income.

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2. Characterization of Asset

Sale or exchanges of patents and copyrights by authors and inventors and certain others closely associated with them are subject to special statutory rules preventing (in the case of authors) or assuring (in the case of inventors) the more favorable tax treatment accorded to long-term capital gains. Other sales or exchange of patents and copyrights are subject to the general provisions of Section 1221 IRC as to whether a capital asset is involved and Section 1231 IRC as to whether a property used in trade or business is involved which is equivalent to capital assets in the tax treatment of gains (but not losses).

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[1] U.S. Constitution, Article I, Section 8.

[2] 35 U.S.C. § 261.

3. Patent Holders Benefited by Section 1235 IRC

This section applies only to a sale of a patent or of an undivided interest in a patent by "any individual whose efforts created such property" or by "any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither the employer of the creator or related to such creator (within the meaning of subsection (d))." The excepted relations are ancestors, spouse and lineal descendants, and certain fiduciaries, corporations, etc. defined in Section 267(b) IRC. Brothers and sisters, whether of the whole or the half-blood are not excepted. Subsection (d) also has the effect of denying to the inventor the benefits of Section 1235 with respect to sales to excepted classes of relatives and controlled corporations (note that the inventor may have the benefit of Section 1235 in the case of a sale to his employer).

The Patent Act requires that the patent be issued to the inventor or inventors or to the assignee or representative of the inventor.[3] The naming as a joint inventor of one who contributed nothing creative is a defect in the patent formerly fatal and still requiring corrections[4] to save the patent. The Senate Finance Committee Report[5] made clear that only an inventor or joint inventor within the meaning of the Patent Act is meant by the expression in paragraph (1) of subsection (b) "individual whose efforts created such property." At the same time the report mentions that paragraph (2) of this subsection is intended to be limited to persons who obtain an interest in the patent in exchange for "consideration capable of present valuation in monetary terms." This would appear to exclude consideration in the form of services unless the parties agree on a monetary valuation, or unless the services are such that they can be valued by reference to prevailing wages or standard schedules of fees. In such case the valuation of the services would appear to be that taxpayer's basis for computing gain subject to Section 1235, and he would appear to be taxable on amounts realized up to but not exceeding the valuation of the services as compensation for services.

Since Section 1235(b)(2) is in terms of when the "money or money's worth" is paid, rather than when the investor acquires his interest, it seems clear the latter does not share in the benefits of Section 1235 unless all of the consideration is paid before actual reduction to practice. Negotiable notes would seem to meet the requirements of the section, however.

4. Time Considerations Under Section 1235

Section 1235 limits non-creative contributions to patents eligible for capital gains tax treatment to those paid to a "creator" of the patent prior to "actual reduction to practice of the invention covered by the patent." The word "actual" is meant to exclude the filing of a patent application, which in a contest for priority counts as a constructive reduction to practice,[6] and it may perhaps also serve to avoid the effect of several tax decisions[7] which, contrary to patent law decisions,[8] held that an invention was reduced to practice when a complete drawing or description is made, regardless of whether it had actually been tried out.

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[3] 35 U.S.C. §§ 101, 115, 116, 117, 118 and 153.

[4] 35 U.S.C. §§ 117, 256.

[5] Sen. Rep. No. 1622 to acc. H.R. 8300, 83d Cong. 2d Sess. (1954) p. 440.

The patent law standard of what is an actual reduction to practice is a strict one, especially in the requirements of proof[9] since the establishment of seasonable reduction to practice may enable an inventor to establish his claim to a patent and defeat the patent of one who was more prompt in filing a patent application. Actual reduction to practice is not required to obtain a patent and may occur for the first time long after the issuance of the patent. Proof of such reduction to practice under Section 1235 must meet all the substantial elements of the invention as defined by a claim of the patent, since the statute refers to the "invention covered by the patent." What any patent covers is defined by its claims,[10] although these claims are not always to be literally construed.[11]

Section 1235 requires no holding period whatever by the eligible holders defined in its paragraph (b). In the case of other sales or exchanges of patents the holding period begins with reduction to practice[12] and is subject to the usual six months minimum to give rise to the capital gains deduction under Section 1202.[13] Constructive reduction to practice (filing of a patent application) ought to be sufficient to begin the holding period, but it is unlikely that so far as actual reduction to practice is concerned a standard different from that which will satisfy Section 1235 would be consciously established.

5. "Transfer" of Patent Rights Under Section 1235

The type of transaction which may yield proceeds entitled to long-term capital gain treatment under Section 1235 is defined as "A transfer (other than by gift, inheritance or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights."

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[6] *Automatic Weighing Mach. Co.* v. *Pneumatic Scale Co.* (1 Cir. 1909), 166 Fed. 288; *Cf.* The Telephone Cases (1888) 126 U.S. 1, 535; *Kear* v. *Roder* (C.C.P.A. 1940) 115 F. 2d 810; See Walker, *Patents* (Deller Ed., New York, Baker, Voorhis & Co. 1937) vol. 1, p. 387. In patent law, reduction to practice corresponds to reducing to possession an item of property which is open to all to capture, such as a wild animal. A mere conception, however fully recorded, is no more than an identification of a quarry to be pursued. The filing of a patent application, supported by its full description, claims, oath and fee, however, is a formal taking of possession by legal process, hence the equivalent for many purposes of an actual reduction to practice.

[7] *Herbert Allen,* par. 52,323 Prentice-Hall Memorandum T.C. (1952); *Edward C. Myers* (1946), 6 T.C. 258.

[8] *Corona Cord Tire Co.* v. *Dovan Chem. Corp.* (1928), 276 U.S. 358; *Kear* v. *Roder,* footnote 6 above. Compare *Jorgensen* v. *Shaff* (C.C.P.A. 1952), 189 F. 2d 264, with *Ericson* v. *Jorgensen* (8 Cir. 1950), 180 F. 2d 180. *Cf. Consolidated Vultee Aircraft Corp.* v. *Maurice A. Garbell, Inc.* (9 Cir. 1953) 204 F. 2d 946, applying this concept in a case involving a contract of employment.

[9] Compare *Reed* v. *Cislak* (C.C.P.A. 1949), 175 F. 2d 972, with *Larsen* v. *Marzall* (D.C. Cir. 1952), 195 F. 2d 200; see Levin, "Corroborative Evidence in Chemical Interferences" (1950) 19 *Geo. Wash. L. Rev.* 201.

[10] *Brooks* v. *Fiske* (1853), 15 How. (56 U.S.) 212; *Keystone Bridge Co.* v. *Phoenix Iron Co.* (1877) 95 U.S. 274; *McClain* v. *Ortmayer* (1891), 141 U.S. 419.

[11] *Graver Tank & Mfg. Co.* v. *Linde Air Prod. Co.* (1950), 339 U.S. 605.

[12] *Samuel E. Diescher,* 36 B.T.A. 732, aff'd (3 Cir. 1940), 110 F. 2d 90, cert. denied (1940), 310 U.S. 650; *Herbert Allen,* footnote 7 above; *Edward C. Myers,* footnote 7 above.

[13] With reference to Secs. 1201 and 1222 to define the effect of Sec. 1202.

The word "substantial" assures that the reservation of a non-exclusive license, a purely nominal title, a right to a retransfer upon default of payment or some other interest regarded as "unsubstantial" [14] or not derogatory of transfer will not exclude a transaction from the benefits of Section 1235.

The defined class of transactions does not extend to territorial divisions of a patent, although the latter are grants rather than licenses and pass by assignment under the express provisions of statute.[15] The qualifying language describing "undivided interest" in the Code also excludes all interests in which the rights of various holders are otherwise differentiated, for example by industries to which the invention might apply, or class of devices,[16] thus distinguishing two court decisions,[17] neither of which actually decided that title to a patent is divisible on such a basis, though both give some support to such a view.

If the rights conferred on the transferee meet the just discussed requirements of Section 1235, it makes no difference that the parties referred to it as a license rather than a sale[18] or, as in one case, stated: "This agreement shall be construed as a license of the aforesaid patents and not as an assignment." [19] In that case the transaction was held to be a sale, but some other authorities were not in accord in such situations.[20] A recent article by Ridsdale Ellis explains the cases by the distinction that where the transferor has made clear that the transferee was to have the right to enforce the patent against infringers, that is a sale; whereas retention of control over infringement suits shows that a substantial property interest rather than a merely nominal title or a security interest has been retained.[21]

A principal provision of Section 1235 makes it immaterial, in the class of transfers coming within the section's terms, "whether or not payments in consideration of such transfer are (1) payable periodically over a period generally coterminous with the transferee's use of the patent, or (2) contingent on the productivity, use, or disposition of the property transferred." This adopts the doctrine of the decisions culminating in the case of *Edward C. Myers*[22] and excludes the considerations raised by the Commissioner's withdrawal of acquiescence in the *Myers* decision.[23]

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[14] *General Aniline & Film Corp.* v. *Commissioner* (2 Cir. 1944), 139 F. 2d 759; *Rohmer* v. *Commissioner* (2 Cir. 1946) 153 F. 2d 61, cert. denied (1945) 328 U.S. 862; *Commissioner* v. *Celanese Corp.* (D.C. Cir. 1944) 140 F. 2d 339; *Allen* v. *Werner* (5 Cir. 1951) 140 F. 2d 840; *Parke Davis & Co.* (1934), 31 B.T.A. 427 (in effect sale of half interest). But *cf.* *Broderick* v. *Neale* (10 Cir. 1953), 201 F. 2d 621, 43 AFTR 213; *Ernest E. Rollman*, 24 T.C. No. 84 (1955). See Sen. Rep. No. 1622, loc. cit. footnote 5 above, outlining this doctrine.

[15] 35 U.S.C. § 261.

[16] 1954 IRC § 1235(a).

[17] *United States* v. *Carruthers* (9 Cir. 1955), 219 F. 2d 12 (entire applicability of invention found within industry to which exclusive license was limited); *Lamar* v. *Granger* (D.C.W.D. Pa. 1951), 99 F. Supp. 17,37, 40 AFTR 1246.

[18] *Allen* v. *Werner*, footnote 14 above; *Hofferbert* v. *Briggs* (4 Cir. 1941) 178 F. 2d 743, 38 AFTR 1218; *Lamar* v. *Granger*, footnote 16 above; *Carl G. Dreymann* (1948) 11 T.C. 153; *Edward C. Myers*, footnote 7 above. *Cf.* *Waterman* v. *Mackenzie* (1891) 138 U.S. 252. See Sen. Rep. No. 1622, loc. cit. footnote 5 above.

[19] *Pike* v. *United States* (D.C. Conn. 1951), 101 F. Supp. 100, 41 AFTR 501.

[20] *Eterpen Financiera S.R.L.* v. *United States* (Ct. Cls. 1952), 108 F. Supp. 100, 42 AFTR 831 cert. den. 74 S. Ct. 22 (1953); *Federal Laboratories Inc.* (1947), 8 T.C. 1150.

[21] Ellis, "Validity of Doctrine that a Full Exclusive License is in Fact an Assignment" (Sept. 1954) 34 *J. Pat. Off. Soc.* 643-659.

[22] Footnote 7, above.

The expression "rights to a patent" was intended to include patent applications along with patents and to apply even to an assignment of the inchoate right to obtain a patent made in advance of the filing of an application for patent.[24] Patent applications are assignable and their assignments are recordable under express provisions of the Patent Act.[25]

Section 1235 applies to past as well as future transactions, being applicable by its paragraph (c) and Section 7851 to amounts received or payments made in taxable years beginning after December 31, 1953. H.R. 6143, which passed the House of Representatives and is pending before the Senate (84th Congress), would amend Section 117 of the 1939 Code by adding a provision similar to Section 1235 of the 1954 act and applying to payments in taxable years beginning after May 31, 1950. Although under this provision certain relatives would not qualify as "holders," as under Section 1235, the bill would permit benefits to the inventor in respect of sales to such relatives, unlike Section 1235.

6. Copyrights as Capital or Business Assets

Section 1221 defining capital assets continues in its paragraph (3) the provision of the Revenue Act of 1950 arbitrarily excluding from capital asset status "a copyright, a literary, musical, or artistic composition, or similar property held by (A) a taxpayer whose personal efforts created such property or (B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property." Section 1231(b)(1)(C) makes a corresponding exclusion in the case of property used in trade or business.

As in the case of Section 1235, but with opposite effect, the provisions just referred to definitively resolve the difficult question, which arose under the older law, of when an author or an inventor could have his creations treated as capital assets when the proceeds of their disposition was taxed.

These enactments do not appear to apply to the heirs of an author nor to the statutory successors entitled to renewal copyrights.[26] Copyrights are granted for a 28-year term, with a renewal right for another 28 years accruing upon application in the twenty-eighth year as an entirely new privilege.[27] If the author is then alive, a previous agreement to assign the renewal copyright will be enforced [28] but if the author dies prior to the twenty-eighth year, such an assignment will not be binding on the successors entitled to renew by § 23 of the copyright law.[29]

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[23] Mim. 6490, I.R.B. 1950-7-13328, 1950-1 C.B. 9.

[24] Conference Report No. 2543 to acc. H.R. 8300, 83d Cong. 2d Sess. (1954) p. 70; Sen. Rep. No. 1622, footnote 5 above, at p. 439.

[25] 35 U.S.C. § 261. Transfers not seasonably recorded are by this section declared void against subsequent purchasers or mortgagees without notice. There is a similar statute regarding copyrights 17 U.S.C. § 30.

[26] Paul Gitlin and Wm. R. Woodward, "Tax Aspects of Patents, Copyrights and Trade-Marks," p. 18, Monograph in series *Current Problems in Federal Taxation*. New York: Practising Law Institute, 3d ed. Jan. 1954.

[27] *Fox Film Corp.* v. *Knowles* (1923), 261 U.S. 326; *White-Smith Music Pub. Co.* v. *Goff* (1 Cir. 1911), 187 Fed. 247.

[28] *Fred Fisher Music Co. Inc.* v. *M. Witmark & Sons* (1943), 318 U.S. 643.

7. Other Sales of Patents and Copyrights

In the case of sale of a patent or copyright by a holder outside of the classes affected by Section 1235 in the case of patents and Sections 1221 and 1231 in the case of copyrights, the usual questions as to whether the property is a capital asset, whether it has been held for at least six months and whether it has been sold rather than merely licensed will arise.

In this connection it is interesting to consider whether the doctrine of the *Myers* case[30] would apply. Since that doctrine was declared in a line of cases dealing chiefly with the taxation of proceeds realized by inventors and since it has been adopted in a section (Section 1235) of the new Code limited to inventors and a limited class of their financial backers, it seems unlikely that the doctrine would be applicable to sales of patents by other subsequent holders in view of the opposition of the Internal Revenue Service announced in 1950[31] to treating payments over a period substantially coterminous with the remaining life of the asset allegedly transferred as anything but ordinary income. This inference is strengthened, with respect to royalties based on productivity, by adoption of another portion of the Code[32] of the expression "economic interest," which is a key phrase in the determination that certain transferors of exhaustible natural resource property are to be taxed as still sharing in the exploitation of the property and obtaining ordinary income therefrom.[33] Furthermore, the Senate Finance Committee expressly stated in its report on Section 1235: "It is the intention of your committee that, if the mode of payment is as described, in subsection (a), the sale of a patent by any 'holder' must qualify under the section in order for such 'holder' to obtain capital gain treatment."[34] This suggests a further expectation that persons not even qualifying as "holders" under subsection (b) would not be entitled to capital gain treatment if the mode of payment were royalties measured by exploitation over the remaining life of the patent.

In cases not controlled by Section 1235, Section 1221(3) or Section 1231(b)(1)(C) the question may also arise whether a grant of exclusive rights limited to a particular industry or class of embodiments of the invention or artistic work will operate as a sale rather than a license. In the case of patents two recent decisions[35] not squarely in point suggested that such grants could be treated as sales, but since these cases dealt with dispositions by inventors and their result was subsequently left outside Section 1235 when the new Code was framed, it seems likely that the courts will hesitate to treat patents as divisible in other tax cases, particularly since there is no tendency to treat them as divisible in the field of litigation to enforce patents against infringers.[36]

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[29] 17 U.S.C. § 23; *Fox Film Corp.* v. *Knowles,* footnote 27 above.

[30] Footnote 7, above.

[31] Footnote 23, above. Accord: Rev. Rul. 54-409, 1954-2 C.B. 174

[32] 1954 IRC § 631.

[33] *Burton-Sutton Oil Co.* v. *Commissioner* (1946), 328 U.S. 25.

[34] Sen. Rep. No. 1622, footnote 5, above, at p. 441.

[35] *Lamar* v. *Granger; Carruthers* v. *United States,* footnote 17, above.

[36] *Cf. Gibbs* v. *Emerson Elec. Mfg. Co.* (D.C. W.D. Mo. 1939), 29 F. Supp. 810, and

In the case of copyrights there is much authority favoring the divisibility view,[37] in spite of somewhat contrary doctrine in infringement litigation,[38] although the Supreme Court was careful to avoid the question when it was presented a few years ago.[39]

8. The Purchaser's Tax Position on Royalties Paid

Where a patent is sold for royalties or other installments, it is obvious that requiring the purchaser to establish straight-line depreciation schedules for each installment with respect to the remaining life of the patent would normally result in a distortion of income, since the depreciation charges would increase continuously towards the end of the term. The only fair way to use the straight-line method of depreciation to charge off the cost against income would be to calculate an equivalent lump-sum purchase price. Although the latter could be calculated in the case of fixed installments upon the assumption of a suitable interest rate and the computation of present values of future payments, the lump-sum value of a royalty based on use of an invention is not subject to reasonably certain approximation. Consequently, it is held that the purchaser of a patent for royalties is entitled to deduct the royalties paid in a particular year as the appropriate charge for depreciation or exhaustion of the patent against income realized in such year.[40] This has the advantage of providing greater depreciation charges in years of greater profits and of avoiding the difficult problem of framing a deduction for obsolescence[41] if the invention should become obsolete or partly so[42] before the expiration of the patent.

Bendix Aviation Corp. v. *Kury* (D.C. E.D. N.Y. 1950), 88 F. Supp. 243, refusing to apply the doctrine of *Independent Wireless Telegraph Co.* v. *Radio Corporation of America* (1926), 269 U.S. 459 to cases of suit by one of two joint owners against an infringer. Perhaps the latter case is applicable today only where the absent party has an "unsubstantial" interest such as appeared in the cases discussed in footnote 14, above.

[37] *Herwig* v. *United States* (Ct. Cls. 1952), 105 F. Supp. 384, 42 AFTR 147; *Joseph A. Fields* (1950), 14 T.C. 1202, aff'd (2 Cir. 1951), 189 F. 2d 950, 40 AFTR 814; *Richard W. Te Linde* (1952), 18 T.C. 91; *cf. Macloon* v. *Vitagraph* (2 Cir. 1929) 30 F. 2d 634.

[38] *Widenski* v. *Shapiro, Bernstein & Co.* (1 Cir. 1945) 147 F. 2d 909; *Goldwyn Picture Co.* v. *Howell Sales Co.* (2 Cir. 1922), 282 Fed. 9, cert. denied (1922), 262 U.S. 755; *Witmark & Sons* v. *Pastime Amusement Co.* (D.C. E.D. S.C. 1924) 298 Fed. 470, aff'd (4 Cir. 1924), 2 F. 2d 1070.

[39] *Commissioner* v. *Wodehouse* (1949) 337 U.S. 369 (1949).

[40] *Associated Patentees, Inc.* (1945), 4 T.C. 979. See Sen. Rep. No. 1622, footnote 5, above, at p. 441 stating: "Such amounts will also be given consistent treatment in the hands of the payor, in that, if the transfer is considered a sale or exchange under the section [1235], they will be regarded as part payments of a purchase price rather than royalties."

[41] *Cf. Hazeltine* v. *Commissioner* (3 Cir. 1937), 89 F. 2d 513, 522; Jordahl & Co. (1937), 33 B.T.A. 1136; see Gitlin and Woodward, *op. cit.*, 73-75, footnote 25, above. "Obsolescence" is specifically mentioned along with exhaustion and wear and tear in Sec. 167(a) and (f) defining the deduction for depreciation.

[42] *O'Neill Mach. Co.* (1927) 9 B.T.A. 567.

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Purchases and Sales of Residences

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With the present inflationary tendencies and before the passage of the Revenue Act of 1951, inequities plagued taxpayers in the sale of an old residence and the purchase of a new one. Although the taxpayer found that he could sell his residence at a price far in excess of its cost basis to him, he discovered that he had to pay as much for a similar residence as he had received for the one he sold. In addition, he had to pay a brokerage commission and other sales expenses on this sale, plus income taxes on the profits, and he found that he was behind in the deal and would have been better off to have kept the old home.

Many times, however, a taxpayer had to move to a new location or he had additions to his family and the old residence became inadequate. At other times he became more prosperous or the neighborhood changed and he desired to move to a new location. In either case he found that he was the loser because he had to pay an income tax and brokerage commissions on the sale of the old residence and, again, his new residence was acquired at inflationary prices. The Revenue Act of 1951, which is discussed later in this chapter, was passed to cure these inequities in that it postponed the recognition of gain until the final residence was sold.

There are many other problems that may arise in the sale of a residence, such as where the property is partly residence and partly business. There are also the problems of timing the sale so as to get the greatest tax benefits, how to take title to the property and the basis problems involved, and the choice of methods of reporting income.

1. Points to Consider

The principal points to be considered are as follows:

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Sale of the residence in general—When does the sale take place? 2
Sale of an old residence and acquisition of a new residence under the Revenue Act of 1951 as adjusted by the 1954 Code 3
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2. Sale of the Residence in General—When Does a Sale Take Place?

The timing of the sale of a residence may be important so as to take advantage of the holding period under the Revenue Act of 1951 as adjusted by the 1954 Code and to report the recognized gain in the most advantageous year.

Under the general terms of the Internal Revenue Code[1] the gain or loss from the sale or other disposition of property is the excess of the amount realized therefrom over the adjusted basis of the property disposed of. The amount realized is the amount of money received plus the fair market value of any property other than money received,[2] including the fair market value of any obligations, such as purchase money obligations which the seller receives. No loss is recognized upon the sale of a residence.[3]

Because of the provision covering the time that must elapse between the sale of an old residence and the purchase of a new residence under the Revenue Act of 1951 as adjusted by the 1954 Code and the various provisions of the state income tax laws, the first question to consider is—When does a sale take place? The states have generally been behind the Federal Government in adopting the provisions of the Federal Income Tax law and even though there are limitations on gain recognized by the Federal Government, these limitations may not apply under the state law. Also, the percentage of gain reportable under the state law may vary according to the time during which the property was held.[4]

The rules vary as to when the profit is reportable depending upon whether the taxpayer is on the cash or accrual basis. A distinction should also be made as to whether there is a contract of sale or an actual sale. An agreement to sell is not a sale, and the sale does not occur until all the conditions of the contract are satisfied.[5] Thus, when there are conditions to be met in the contract, the sale takes place when these conditions are met and the title to the property has passed.[6]

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[1] 1954 IRC § 1001(a); 1939 IRC § 111(a).

[2] 1954 IRC § 1001(b); 1939 IRC § 111(b).

[3] Reg. 118 § 39.23(e)-1(e).

[4] See California Income Tax law as set forth by Russell Bock in *California Income Taxes*, published by Commerce Clearing House, para. 513. California has granted the privileges of the Federal Income Tax law on sales and purchases of residences for sales occurring after December 31, 1951. See para. 502a of above.

[5] *Hellman* v. *U.S.* (Ct. Cls. 1930), 44 F. 2d 83, 9 AFTR 249. Similarly, though part payment made in cash at time agreement signed, *Com.* v. *Segall* (6 Cir. 1940), 114 F. 2d 706, 25 AFTR 698, cert. den. 313 U.S. 562. Also, *Number Nine Plantation*, 23 B.T.A. 974 (Acq.) (1931).

In 1922 vendor agreed to sell its plant and paid 10% at that time. The vendor was to retain possession of the property, operate it, and retain the revenues until 1923. The Board held that the sale occurred in 1923 when the deed was to pass and the balance of the purchase price paid. *Newaygo Portland Cement Co.*, 27 B.T.A. 1097 (Acq.) (1933).

[6] *Lucas* v. *North Texas Lumber Co.*, 281 U.S. 11, 8 AFTR 10276 (1930); appeal of *Waggoner*, 9 B.T.A. 629 (1927); *Murren* v. *Com.*, 18 B.T.A. 156 (1929); in *Bassett* v. *Com.*, 33 B.T.A. 182 (1935), the Board said: "What has generally been made decisive of the receipt of income by a taxpayer is whether he may exercise an unlimited command over it; and this holds true although for collateral or other reasons he may eventually have to part with some or all of it later on." See also *Federal Development Co.*, 18 B.T.A. 971 (1930); *Bumbaugh*, 10 B.T.A. 672 (1928); *Bedell* v. *Com.* (2 Cir. 1929), 30 F. 2d 622, 7 AFTR 8469. In *Griffith Exec.*, 10 B.T.A. 799 (1928), an agreement of sale was made in 1920 containing the

It is thus possible for the seller to control the time of sale or his method of reporting income (as in the case of instalment sales discussed later in this chapter) by entering into a contract of sale whereby the sale will not be completed until the desired time. The question arises as to when is a real estate transaction closed? Generally several factors must be considered, as no one factor controls. The closing may be at the time of delivery of a deed, or at the time possession and the burdens and benefits of ownership are, from a practical standpoint, transferred to the buyer, whichever occurs first.[7]

A sale may be considered as consummated even though it is impossible to determine the entire consideration for the sale. A classical case on this point was decided by the United States Supreme Court in 1936.[8] In that case, part of the consideration for the sale was the promise to pay 60 cents a ton on all iron ore mined on the property, with no agreement as to any minimum or maximum amount to be mined in any year. The court held that a sale had taken place but that no gain would be reportable until after the basis of the property had been recovered. This problem may arise on the sale of a residence.

The gain on the sale of a residence is considered a capital gain as this is not property excluded from capital assets under Section 1221 of the 1954 Internal Revenue Code. On the other hand, a loss from the sale of a residence is not deductible under Section 165(c)(1) and (2) of the 1954 Code (Section 23(e)(1) and (2) of the 1939 Code), which permits losses sustained by an individual only if incurred in a trade or business, or in a transaction entered into for a profit. The owning of a residence is not considered as a transaction entered into for a profit.

An interesting exception to the above is a memo decision handed down by the Tax Court[9] on February 19, 1953. In that case the taxpayer was engaged in the business of the construction and sale of houses. He purchased a plot of land for the purpose of the subdivision and construction of residences thereon for sale to the public. The title examination disclosed an easement on the land which necessitated the abandonment of the subdivision; however, improvements were made on a house on the plot and a "for sale" sign placed on the house, and it was listed with real estate brokers. There was vandalism to the house and surrounding property and the taxpayer moved into the house and lived there for five years, when the house was sold at a loss of about $11,800. The court allowed the loss in full and quoted from *Henry J. Gordon*, 12 B.T.A. 1191 (1928) as follows: "Where a taxpayer acquires property with the intention of selling it at a profit, even though he may have resided thereon, if the predominant factor in its selection was the prospect of future profits, he is entitled to any loss upon the sale thereof." The

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words "has this day sold" but providing that certain acts were to be performed in 1921. The Board held that the sale took place in 1921 when these acts were performed. In *Lucas* v. *North Texas Lumber Co.*, 281 U.S. 11 (above), the Supreme Court held that the sale was not complete when there was no unconditional liability on the part of the purchaser for the purchase price and the seller had not acquired the right to possession or title.

[7] I.O. 988, 2 C.B. 84 and A.R.R. 13, 2 C.B. 78; *Wurtsbaugh*, 8 T.C. 183 (Acq.) (1947); *Chapin, et al.*, 12 T.C. 235 (1949). In appeal of *Bernard Long*, 1 B.T.A. 792 (1925) and appeal of *Arthur Long*, 1 B.T.A. 796 (1925), the sale was considered consummated at the time of delivery of the deed, even though the seller remained in possession and received the rents until the lease had expired.

[8] *Burnet* v. *Logan*, 283 U.S. 404, 9 AFTR 1453 (1936).

[9] *Tillotson* v. *Comm.* 53056 Prentice-Hall Memorandum T.C. (1953).

court held that the use of the property as a residence in this case was merely incidental to the dominant purpose, which was to hold the property for sale to customers in the ordinary course of the taxpayer's business.

3. Sale of an Old Residence and Acquisition of a New Residence under the Revenue Act of 1951 as Adjusted by the 1954 Code

Under Section 1002 of the 1954 Code, the entire amount of gain or loss from the sale of property is to be recognized, with certain exceptions provided for in other parts of the Code. The first of these exceptions is in Section 1031(a), wherein it is provided that no gain or loss shall be recognized if "property held for productive use in trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment." An early Bureau ruling[10] held that a residence is not property held for investment and the gain upon such an exchange is recognized, but not a loss. The purpose for which the property is held applies to both the property exchanged and the property received so that where a residence is involved, whether the residence is exchanged for another residence or for business property, or whether business property is exchanged for a residence, the gain would be recognized. This applied until the addition of Section 112(n) to the Code by the Revenue Act of 1951 (which is Section 1034 of the 1954 Code). Problems arise when the property is partly business, such as rental, and partly residential. These will be discussed later in this chapter.

Another exception to Section 1002 is an involuntary conversion under Section 1033. By this section of the Code, if property is compulsorily or involuntarily converted into other property because of a condemnation or threat or imminence thereof, or because of destruction in whole or in part, etc., then no gain will be recognized to the extent that the proceeds were used to acquire similar property It is not part of the purpose of this chapter to discuss the rules for the application of this section. An involuntary conversion would apply to residential property, as there is no restriction as to the purpose for which the property is held.

With the inflationary tendencies now going on, Congress recognized the inequities existing in the recognition of gain on the sale or exchange of personal residences and added Section 112(n) to the Code (Section 1034 of the 1954 Code), wherein the sale or exchange of a personal residence and the acquisition of a new residence is treated similarly to, although not the same as, an involuntary conversion.

Although the new section of the Code applies to sales of residences after December 31, 1950, the Regulations[11] of the Commissioner on these provisions were not approved until February 1953. These regulations state[12] that the nonrecognition of the gain is mandatory and not permissive. The Code[13] used the word "shall" and, therefore, the taxpayer does not have an election whether or not he should report the gain and get a stepped-up basis for his new residence. If he does comply with the conditions set forth, then the basis of the new residence must be adjusted in the manner set forth by the Code.

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[10] I.T. 1587, II-1 C.B. 26.

[11] Reg. 118, § 39.112(n)-1, added by T.D. 5991, approved Feb. 17, 1953.

[12] Reg. 118, § 39.112(n)-1(a).

[13] 1954 IRC § 1034(a); 1939 IRC § 112(n)(1).

The provisions apply only to the "principal" residence of the taxpayer and to only one sale or exchange during one year. The Code provides that if the taxpayer's principal residence is sold by him, and within one year prior to the date of the sale or one year thereafter a new residence is purchased and *used by him* as his principal residence, the gain from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence. This concept of "adjusted sales price" is a change from the 1939 Code and will be discussed later in this chapter. If there is an exchange of residences, this will be considered as a sale of the old one and purchase of a new residence. If the property is involuntarily converted, for instance if destroyed by fire and insurance is received and a new residence erected with the proceeds, this is to be considered as a sale of the old residence and the purchase of a new residence if it occurred after December 31, 1950 and before January 1, 1954. If it occurs after December 31, 1953, then the rules of involuntary conversion, in Section 1033 of the 1954 Code, apply. If the taxpayer starts the construction of a new residence within one year after the sale of the old residence, then it must be *occupied* within eighteen months after the sale of the old residence.

Problems may arise as to what is the "principal" residence of the taxpayer if he has more than one place of abode. The Regulations[14] state that this depends upon all of the facts and circumstances in each individual case, "including the bona fides of the taxpayer."

The Regulations state that the mere fact that the property has been rented is not determinative. Thus, the taxpayer may rent the old residence temporarily after acquiring the new one until he has an opportunity to sell the old residence, or he might temporarily rent the new residence until he disposes of the old one.

The Code[15] also provides that principal residence shall include stock held by a tenant-stockholder in a cooperative apartment house where the apartment which the taxpayer was entitled to occupy, as such stockholder, was used by him as his principal residence. This applies to the purchase of such stock as well as to its sale. The regulations[16] say that the principal residence may also include a houseboat or a house trailer.

The Code provides that a residence, any part of which was constructed or reconstructed by the taxpayer, shall be considered as purchased by him but only to the extent of that portion of his cost as is attributable to the acquisition, construction, reconstruction and improvements made which are properly chargeable to capital account during one year before and one year or eighteen months after the sale. The regulations[17] further provide that "the mere improvement of a residence, not amounting to reconstruction, does not constitute a purchase of a residence."

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[14] Reg. 118, § 39.112(n)-1(b)(1).
[15] 1954 IRC § 1034(f); 1939 IRC § 112(n)(5).
[16] Reg. 118, § 39.112(n)-1(b)(1).
[17] Reg. 118, § 39.112(n)-1(b)(3).

As previously stated, the Code recognizes the purchase of only one principal residence within one year after the sale of an old residence, and this is the last such purchase. The 1939 Code (Section 112(n)(2)(F)) provided that if there was an involuntary conversion of one of these residences, then the year would end on that date. This has been omitted from Section 1034(c)(4) of the 1954 Code.

An example of the foregoing, under the 1939 Code, as set forth in the regulations,[18] follows: "A taxpayer sells his old residence on January 15, 1952 and purchases a new residence on February 15, 1952. On March 15, 1952 he sells the new residence and purchases a second new residence on April 15, 1952. The gain on the sale of the old residence on January 15, 1952 will not be recognized except to the extent to which the taxpayer's selling price of the old residence exceeds the cost of purchasing the second new residence on April 15, 1952. Gain on the sale of the first new residence on March 15, 1952 will be recognized. If instead of selling the first new residence on March 15, 1952 such residence had been destroyed by fire on that date and insurance proceeds in cash had been received as a result thereof, the gain on the sale of the old residence on January 15, 1952 will not be recognized except to the extent to which the taxpayer's selling price of the old residence exceeds his cost of purchasing the new residence on February 15, 1952. And, the gain on the involuntary conversion by fire of the first new residence on March 15, 1952 will not be recognized except to the extent to which the amount realized from such conversion exceeds the taxpayer's cost of purchasing the second new residence on April 15, 1952."

Under the 1954 Code the involuntary conversion would be subject to the rules under Section 1033 of the Code and would be classed as an involuntary conversion. The term "selling price" would be "adjusted sales price" and the selling expenses and the expenses for work performed on the old residence, as limited by Section 1034(b), would be deducted from the selling price.

Basis of new residence. The Code[19] provides that the cost of the new residence shall be reduced by the amount of gain not recognized because of this section but "only so much of such gain as is not recognized by reason of the cost up to such time of purchasing the new residence."

Example:[20] On January 1, 1952 the taxpayer buys a new residence for $10,000. On March 1, 1952 he sells for $15,000 his old residence which has an adjusted basis to him of $5,000. In April he constructs a wing on the new house at a cost of $5,000, and in May he builds a garage at a cost of $2,000. Since the basis of the new residence is a substituted basis, the holding period of the old residence will be tacked onto the holding period of the new residence. See Table on the next page.

Special rules for husband and wife.[21] If the taxpayer and his spouse file the required consent, the taxpayer and his wife may purchase a new residence in the name of either spouse or both even though the title to the property sold is held differently. Such consent may only be filed if both the old and new residences are

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[18] Reg. 118, § 39.112(n)-1(d)(2), Example.

[19] 1954 IRC § 1034(e); 1939 IRC § 112(n)(4).

[20] Reg. 118, § 39.112(n)-1(c), Example.

[21] 1954 IRC § 1034(g); 1939 IRC § 112(n)(6); Reg. 118, § 39.112(n)-1(b)(6).

Selling price of old residence—March 1, 1952	$15,000
Less adjusted basis	5,000
Gain not recognized	$10,000
Cost of new residence—January 1, 1952	$10,000
Cost of new wing—April, 1952	5,000
Cost of garage—May, 1952	2,000
Total cost	$17,000
Less gain not recognized	10,000
Basis of new residence	$ 7,000

used by the taxpayer and his same spouse as their principal residence. This consent means that the spouses both consent to the adjustment in basis of the new residence by the gain not recognized because of this section of the law. "Such consent shall be filed with the officer with whom the return for the taxable year or years in which the gain from the sale of the old residence is realized has been filed."

Examples:[22] 1. In 1952 a taxpayer sells for $10,000 the principal residence of himself and wife, which he owns individually, and which has an adjusted basis to him of $5,000. Within one year thereafter he and his wife each contribute $5,000 from their separate funds and acquire a new principal residence as tenants in common. If they file the required consent, the adjusted basis of each will be $2,500.

2. Taxpayer and wife own a principal residence as joint tenants with an adjusted basis of $2,500 to each ($5,000 together). In 1952 they sell this for $10,000. Within one year the wife spends $10,000 from her own funds and purchases a new principal residence for herself and husband and takes title in her own name only. If the taxpayer and his wife file the required consent the wife will have a basis for the new residence of $5,000.

Statute of Limitations.[23] The period within which the Commissioner may assess any deficiency attributable to any gain arising from the sale of the property is three years from the date the officer with whom the return in the year the gain from the sale was realized is notified by the taxpayer of: (1) cost of the new residence, or (2) taxpayer's intention not to, or failure to, purchase the new residence. This is notwithstanding any other law or rule of law which might otherwise bar the assessment of a deficiency.

The regulations state that this notification shall be made in the return for the year of purchase, or intention not to purchase, or at the expiration of the year in which it should have been purchased. If the return is not filed with such officer, then he shall be notified at the time of filing this return with another officer. If a new residence is not purchased within the prescribed time, then an amended return reporting the gain should be filed for the year of the sale.

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[22] Examples 1 and 2 in Reg. 118, § 39.112(n)-1(b)(6)(iii).

[23] 1954 IRC § 1034(j); 1939 IRC § 112(n)(7); Reg. 118, § 39.112(n)-1(e).

Extension of time for acquiring a new residence allowed to members of the armed forces.[24] The running of the one-year or eighteen-month period for the occupying of a new residence shall be suspended during any time that the taxpayer serves on extended active duty in the Armed Forces of the United States after the date of sale of the old residence, but this will not be extended beyond four years from the date of sale of the old residence. This applies to the spouse as well as to the taxpayer if both of them used both the old and the new residences as their principal residence. Extended active duty is defined as any period of active duty which is served pursuant to a call or order to such duty for a period in excess of ninety days or for an indefinite period. If it is for a period more than ninety days, or for an indefinite period, it is immaterial that he might have served a shorter period if this occurs after the beginning of such duty. The 1939 Code states that this must be before January 1, 1954, but the 1954 Code eliminated this cut-off date.

Example: The taxpayer is on extended active duty with the Army from January 1, 1951 to December 31, 1953. The old residence is sold January 1, 1951. The latest date that he has to occupy a new residence constructed by him and have any part of the gain not recognized is January 1, 1955, or four years after the date of the sale of the old residence.

Adjusted sales price of old residence[25] **and cost of new residence.**[26] The adjusted sales price of the old residence includes the amount of any obligations to which the property is subject, whether or not the purchaser assumes such obligations, and the face amount of any liabilities of the purchaser which are part of the consideration for the sale reduced by the aggregate of the expenses for work performed on the old residence in order to assist in its sale. This latter applies only to expenses for work performed during the ninety-day period ending on the day on which the contract to sell the old residence is entered into and which is paid on or before thirty days after the sale and which are not otherwise allowable as deductions on the return. This would include selling expenses. If there is an exchange, he should include the fair market value of the property received upon the exchange. Section 112(n)(1) of the 1939 Code used the words "selling price" and did not allow the deduction of the expenses of sale. The 1954 Code changed this by substituting the words "adjusted sales price."

The cost of the new residence includes the same elements as mentioned above under the selling price and also any commissions and other purchasing expenses paid or incurred by the taxpayer. It includes only so much of such cost as is attributable to acquisition, construction, reconstruction, or improvements made within the two-year or thirty-month period specified and only so much as is properly chargeable to capital rather than expense. If it is acquired by any other means than by purchase or exchange, the value of such part is not included in the cost of the new residence.

Example: If the property is acquired by gift or inheritance, and during the prescribed time $20,000 is expended in reconstructing this residence, only the $20,000 may be treated as his cost of purchasing the new residence.

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[24] 1954 IRC § 1034(h); 1939 IRC § 112(n)(8); Reg. 118, § 39.112(n)-1(f).

[25] 1954 IRC § 1034(b); Reg. 118, § 39.112(n)-1(b)(4).

[26] Reg. 118, § 39.112(n)-1(b)(5).

4. Problems Where Property is Partly Residence and Partly Business

Problems arise where a property owner converts his residence to rental or other business property or where he has a multiple family dwelling wherein he occupies part of the premises as his residence and rents another part of it. Residential property, as noted previously, is considered as a capital asset, whereas rental property comes within the exclusions from capital assets as being "property, used in his trade or business, of a character which is subject to the allowance for depreciation." [27] Therefore, any loss on its sale is allowable in full as an ordinary loss under Section 165(c) of the 1954 Internal Revenue Code and any gain, if the property is held more than six months, is a capital gain under Section 1231 of the Code (Section 117(j) of the 1939 Code).

Another problem arises, which will be considered at the end of this section, when the taxpayer has an estate or acreage as his residence and decides to subdivide it.

We will first consider the conversion of residential property into business property and its sale at a loss. This question was decided by the United States Supreme Court in 1928 in *Heiner* v. *Tindle.*[28] In that case the taxpayer acquired a residence in 1892 at a cost of $172,000. He occupied it until 1901, when it was rented until its sale in 1920 for $73,000. The fair market value on March 1, 1913 was $120,000. The value in 1901 is not stated. Under the Revenue Act of 1918 losses were allowable "if incurred in a transaction entered into for profit." However, no deduction was allowable for "personal, living or family expenses" and the Regulations provided that the loss from the sale of a taxpayer's residence was not deductible. The Commissioner tried to hold that, since the property was acquired for residential purposes, it was not "a transaction entered into for profit." The court held that when the house was rented it then became a "transaction entered into for profit" and the basis of the loss allowed would be the value when it was rented in 1901, the cost, or the March 1, 1913 value, whichever was lowest. As the law now stands,[29] in the case of a loss, the fair market value at March 1, 1913 is disregarded and the basis of residential property converted to rental property is the cost or the value at the date it was converted to rental, whichever is the lesser. This is also the basis for depreciation of the property. At the time of the sale of the property the basis must be adjusted for subsequent improvements and depreciation allowed.

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[27] 1954 IRC § 1221(2); 1939 IRC § 117(a)(1)(B). See *Hazard* v. *Com.*, 7 T.C. 372 (1946) (Acq.), wherein an attorney owned and occupied a residence in Kansas City, Mo. He abandoned the house as a residence, moved to Pittsburgh, then rented the Kansas City house until it was sold later at a loss. The Court said that, even though his principal business was that of an attorney, a taxpayer may have more than one business, and the rental of a house, even one house, is a business, and therefore this was property used in trade or business of a character subject to the allowance for depreciation. The loss was allowable in full under Section 23(e) of the Internal Revenue Code. As authority it gave *John D. Fackler*, 45 B.T.A. 708, affirmed (6 Cir. 1943) 122 F. 2d 509, 30 AFTR 932.

[28] 276 U.S. 582, 6 AFTR 7366 (1928).

[29] 1954 IRC § 1053; 1939 IRC § 113(a)(14).

Problem: In 1942 a taxpayer purchased a residence for $20,000, of which $2,000 was for the land and $18,000 for the house. Due to the war and the influx of undesirable people, the value of the property declined, and on January 1, 1944 he moved out and rented the property. At that time its fair market value was $17,000, of which $16,000 was for the house and $1,000 for the land. The remaining life at that date was 32 years. He had a new garage built on the property, which was completed January 1, 1950 at a cost of $1,000. On January 1, 1950 he sold the house for $13,000.

Value of property—January 1, 1944	$17,000
Additional cost of garage	1,000
	$18,000
Less depreciation—6 years at $500	3,000
Adjusted basis	$15,000
Selling price	13,000
Loss—allowable in full under Sec. 165 of the 1954 Code (or Sec. 23(e) of the 1939 Code)	$ 2,000

If the house were sold for $20,000, the gain would be computed as follows:

Cost in 1942	$20,000
Additional cost of garage	1,000
	$21,000
Less: depreciation	3,000
Adjusted basis	$18,000
Selling price	20,000
Capital gain—long term	$ 2,000

If the house were sold for $19,000, there would be neither a gain reportable nor a loss allowable.

What must be done in order to convert a residence into business property? The courts[30] have held that the mere listing of the property for rent or for sale is not sufficient to convert it into a transaction entered into for a profit so as to justify a loss deduction upon its sale. It actually must be rented before the sale.

Many problems arise when a taxpayer uses part of the property for rental and part for a residence. There must be an allocation made of both the basis and the sales price between the residential portion and the rental portion. Because of the allowance for depreciation on the rental portion, it is possible to have a loss on the portion devoted to residential purposes, which is not allowable, and a gain on the portion allocated to rental. This may best be illustrated by the following problem:

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[30] *Peck* v. *Com.,* 34 B.T.A. 402 (1936); *Mary Louise Bok* v. *Com.,* 46 B.T.A. 678 (Acq.) (1942); *Kimbell* v. *Com.,* 41 B.T.A. 940 (1940); *Grammar* v. *Com.,* 12 T.C. 34 (1949).

		Total		*Residence*		*Rental*
Selling price		$24,000		$12,000		$12,000
Less—adjusted basis		22,200		12,500		9,700
Cost	$25,000		$12,500		$12,500	
Less—depreciation	2,800		xx		2,800	
Gain or loss		$ 1,800		$ (500)		$ 2,300

The loss of $500 would be disallowed as the loss from the sale of a personal residence and there would be a capital gain of $2,300 on the sale of the residential portion.

Other problems will arise, outside the scope of this chapter, and will be touched upon only briefly, as to the reporting of the income from the rental portion and the apportionment of deductions. Under Section 62(5) of the 1954 Code (Section 22(n)(4) of the 1939 Code) the expenses of rental property are allowable in arriving at Adjusted Gross Income. This is important as the taxpayer may get those deductions in arriving at Adjusted Gross Income and still use the Standard Deduction. Repairs and maintenance, utilities, insurance, and other expenses of the property should be prorated between the residential portion and the rental portion. Those attributable to the residential portion of the property are not deductible whereas those attributable to the rental portion may be deducted for adjusted gross income and the taxpayer would be entitled to the standard deduction as well. Depreciation may also be deducted on the rental portion but not on the residential. Taxes and interest should be apportioned and those applying to the rental portion may be deducted and the taxpayer still can claim the standard deduction.

We will now consider the problems of the residence owner who has a large estate or acreage as his residence and wishes to subdivide it and sell the individual lots. In many cases the taxpayer would be better advised to sell the entire property to one buyer because, if he attempts to subdivide the property into lots and to enter into a campaign to sell the lots, he may find that he will be classified as a dealer in real estate and not entitled to capital gains on the sale. Even though he may receive higher prices for the lots than he would for the sale of the entire property, the difference in tax rates between a capital gain on the sale of the entire property and ordinary tax rates on the sale of the lots may leave him more after taxes than if he received the higher prices for the lots. See Section 1237 of the 1954 Code for the rules on real property which is subdivided wherein if certain conditions are met, transactions noted above will not be denied capital gains.

It is not the purpose of this chapter to discuss the elements determining whether or not a taxpayer is a dealer in real estate. That will be discussed elsewhere in this book. It will be sufficient here to say that there are cases[31] which say that where property is subdivided and there is a campaign for the sale of the lots, the taxpayer becomes a dealer in real estate and is not entitled to capital gains. This will depend largely on the number of lots sold each year and the extent of the sales campaign or if the provisions of Section 1237 of the 1954 Code are met.

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[31] *Richards* v. *Com.* (9 Cir. 1936), 81 F. 2d 369, 17 AFTR 360, where a farm was subdivided into lots, improved, and advertised for sale and sold through agents over a period of about 3 years. *Mauldin* v. *Com.* (10 Cir. 1952), 195 F. 2d 714, 41 AFTR 1126.

5. Basis of Residential Property—How Should the Title be Taken?

In acquiring a residence, consideration should be given as to how the title should be held between husband and wife, as this may be the determining factor as to how gain should be reported upon a future sale, especially if one of the spouses should die before the residence is sold. In a recent article in the *California Law Review,*[32] the author states that he was informed by an officer of a Title Insurance Company that 85 per cent of all real property acquired by husband and wife is in joint tenancy. Of course, this applies to California and other states where joint tenancy is in vogue, but similar conditions may apply in states where the common law tenancy by the entirety exists between husband and wife. The parties are generally thinking about the ease of passing title upon death in a joint tenancy, and the lack of probate, but more serious problems arise as to estate tax and income tax problems at the time of death in either joint tenancy or tenancy by the entirety. These problems will be discussed after a general consideration of basis problems of residential property.

The Internal Revenue Code[33] provides that the gain from the sale or other disposition of property is the excess of the amount realized therefrom over the adjusted basis for determining gain. The adjusted basis[34] of such property is the basis plus any additions to the property of a capital nature less the depreciation allowed or allowable from the date of the acquisition to the date of disposition. Among the additions to the original basis would be found the following:

1. Capital improvements made to the property, such as the addition of new rooms, landscaping, building of retaining walls, and other improvements adding to the value of the property, which are not mere maintenance in nature.
2. Improvement assessments[35] made against the property as for new streets or sewers.
3. Property acquired after the date the property taxes became a lien against said property; such property taxes paid by the buyer until the next assessment date must be added to the cost of the property.[36] This has been corrected by Section 164(d) of the 1954 Code, wherein it is provided that real estate taxes are to be apportioned between the seller and buyer and the latter may deduct the portion of such taxes applicable to the period after the date of sale.

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[32] Arthur K. Marshall, "Joint Tenancy, Taxwise and Otherwise," *California Law Review,* Winter 1952-53, Vol. 40, No. 4, footnote No. 2 at bottom of page 501.

[33] 1954 IRC § 1001(a); 1939 IRC § 111(a).

[34] 1954 IRC § 1016; 1939 IRC § 113(b).

[35] 1954 IRC § 164(a)(5); 1939 IRC § 23(c)(1)(E).

[36] *Supplee* v. *Magruder,* 316 U.S. 394, 29 AFTR 196 (1942). For instance, in California the assessment or lien date is the first Monday in March of each year. (*California Sanitary Co., Ltd.,* 32 B.T.A. 122 (1935). The assessment is made based upon the value of the property as of that date and to the person who had record title to the property on that date; however, the actual amount of assessment and tax will not be shown until sometime later. The tax bill contains the name of the party who had record title on that date. A property owner in California who acquires title to property after that date must add to the basis of the property the taxes due for that year, due in November or December of that year, and in March or April of the following year.

The Code[37] provides that the basis of such property shall be cost, except in the following instances:

1. If the property was acquired by gift before January 1, 1921,[38] the basis is the fair market value at the time of such acquisition.
2. If the property was acquired by gift after December 31, 1920,[39] the basis depends on whether there is a gain or a loss upon disposition. If there is a gain, it is the basis in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If there is a loss, it will be that basis, or the fair market value at the date of the gift, whichever is lower.
3. If the property was acquired prior to March 1, 1913,[40] the effective date of the first income tax law under the Sixteenth Amendment, the basis would depend on whether there is a gain or a loss. If there is a gain, the basis is the higher of the cost or the fair market value on that date. If there is a loss, the basis is the original cost.
4. If the property was acquired by inheritance,[41] the basis is the fair market value at the date of death, unless the executor elects to use the value one year later under Section 2032 of the 1954 Code (Section 811(j) of the 1939 Code), when that value will be used. The simple rule to follow is to use the value as finally determined for estate tax purposes. If no estate tax return need be filed, then use the value established by the state inheritance tax appraiser for inheritance tax purposes.

The author has found that in order to save a small amount of inheritance and estate taxes, many attorneys and taxpayers have endeavored to secure low values on the property and have found, to their sorrow, that when the property was sold later, more income taxes had to be paid than were saved in inheritance and estate taxes. Consideration should be given to this factor in evaluating property transmitted by death, especially where the estate is small. There are several special problems that should be considered at this point in connection with property transmitted at death:

a. Community property. In most community property states the wife has a vested interest in one-half of the community property, which she may transmit by will. As a result, before the change of the Estate Tax Law in 1942, only one-half of the community property was included in the husband's estate, and the same was true in the case of the death of the wife. As a result, upon the death of either spouse, with the community property being left to the other, one-half of such property would be valued at its prior basis and one-half at the value at the date of death.[42]

Under the Revenue Act of 1942 it was provided that the entire community property, if death occurred after October 21, 1942, would be included in the gross estate to the extent that it arose from the earnings of the decedent. The Bureau, however, continued to hold to the rule noted for deaths prior to October 21, 1942 as to the basis of the property in the hands of the survivor.

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[37] 1954 IRC § 1012; 1939 IRC § 113(a).
[38] 1954 IRC § 1015(c); 1939 IRC § 113(a)(4).
[39] 1954 IRC § 1015(a); 1939 IRC § 113(a)(2).
[40] 1954 IRC § 1053; 1939 IRC § 113(a)(14).
[41] 1954 IRC § 1014; 1939 IRC § 113(a)(5).
[42] *Waters* v. *Com.*, 3 T.C. 407 (1944).

In 1948, in an attempt to equalize the tax consequences of holding property in community property and non-community property states, Congress provided that only one-half of the community property would be included in the gross estate, and the marital deduction would take care of one-half of the separate property of the decedent. It was therefore provided that if any part of the surviving spouse's one-half of the community property was included in determining the gross estate, and any estate tax was payable thereon, then, in effect, the surviving spouse had the election of using the basis which had applied previously, or applying the fair market value at the date of death to the entire property if death occurred after October 21, 1942 and before January 1, 1948. If death occurred after December 31, 1947, and at least one-half of the community property is includible in determining the value of the gross estate, then the basis of the community property is the fair market value at the date of death or one year later, if an election is made under Section 2032 of the 1954 Code. In other words, it is considered the same as any other property transmitted at death.

b. Joint tenancy or tenancy by the entirety. There are several ways in which a husband and wife may hold title to a personal residence. It may be held in the individual name as the separate property of either spouse, as tenants in common whereby each spouse has an undivided interest in the property, or in joint tenancy or tenants by the entirety.

In some of the western states, where Spanish law originally existed, or where the states are near such states and have adopted part of the Spanish law, the community property system prevails. As noted previously, under this system the wife has a vested interest in one-half the community property.[43] We will not discuss here the laws of the various states as to what is considered community property, as the laws governing such property differ in the various states. In some of the common law states the wife has a dower one-third interest in all lands to which the husband had title during the marriage. This right has been held to be a mere expectancy to be secured upon the death of the husband.

In some states the husband and wife may hold title to property as joint tenants;[44] while in others they may hold as tenants by the entirety. Both of these are similar as to the tax effects. Although, except for the marital deduction, there may be a gift tax due on one-half of the value of the property at the time it is put in joint tenancy, because of the peculiar nature of such method of holding title, both spouses are considered as owning the property from the beginning, and the basis of such property at the time of the sale, before the 1954 Code, was held to be the original cost.[45] For estate tax purposes, the entire value of such property must be included in the gross estate, except for the portion of the consideration contributed by the surviving spouse. The marital deduction may reduce the estate tax on part of this value.

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[43] In California, the Spanish system of community property was adopted as to property holdings between husband and wife and the common law as to all other matters. As a result, a great deal of confusion developed as to the nature of California community property. The wife has the right of testamentary disposition of one-half of all community property acquired after 1923. However, the courts held that she had a mere expectancy in this property and did not receive a vested right. The California Civil Code was amended so that she received what has been interpreted as to be a vested interest in it.

This amendment was effective July 29, 1927, so that now there is considered to be two types of community property, the old type as to all community proprety acquired prior to July 29, 1927, and the new type as to all community property acquired after July 29, 1927.

[44] In California a great deal of confusion now exists as to property in which title is held in joint tenancy. The courts have held that even though the title is held in joint tenancy, it can be shown by parol evidence that the real intention was that such property be regarded as community property. See article in Note 32 above, and the following cases: *U.S. v. Paorotti* (9 Cir. 1946), 154 F. 2d 758, 34 AFTR 1140; *Tomaier v. Tomaier*, 23 Cal. 2d 754.

As a result, before the 1954 Code, with the present inflationary tendencies, if property was held in joint tenancy and one of the spouses should die, the surviving spouse, upon the sale of the property, was required to use the original basis as his basis, even though an estate tax had to be paid on a much higher value. If there was a declining market and the property was acquired at or near the peak of the market, there might have been an advantage in holding the title in this manner as the taxpayer would then get a higher basis than the fair market value at the date of death.

An attempt has been made to cure this inequity by Section 1014(a)(9) of the 1954 Code. This provides that if the death occurs after December 31, 1953 and such property is required to be included in determining the value of the gross estate, then the basis shall be this value less any depreciation previously allowed if the property was acquired before the death of the decedent. It does not appear that this entirely cures the problem when the joint tenancy property was acquired with community funds. Under Sec. 2040 of the 1954 Code such property would be included in the gross estate to the extent that the decedent contributed to the cost of acquisition. If the property was acquired with community funds, therefore, as the survivor contributed one-half of the cost, only one-half of the value of the joint tenancy property would be included in determining the value of the gross estate. As a result the joint tenancy property would only get a new basis as to one-half and the other one-half would retain its old basis. If it remained community property and was not converted into joint tenancy a new basis would be acquired as to the entire property. Also, in community property there is no requirement for a reduction of the value for depreciation previously allowed.

The old rules prevail as to joint tenancy property where the death occurred prior to January 1, 1954.

At this point a few remarks should be made about holding property as tenants in common. Under this method the parties own an aliquot part of the property. If one of the spouses receives the entire interest in the property at the date of death of the other spouse, the basis must be allocated between the part originally owned by the spouse and the part inherited from the deceased spouse.

Thus it can be seen that when there is a rising market in real estate, it is often-times better to take title to property as the separate property of one of the spouses, or as community property in the case of community property states, and allow the property to pass by inheritance than to take the title in the joint names of both spouses at the time of the acquisition of the property. Although there may be some inconvenience in the necessity of probating the property at the time of death of the spouse in whose name the title is held, the tax consequences of getting a new and higher basis at the time of death of the decedent outweigh the disadvantages noted.

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[45] As to the basis of joint tenancy property to the survivor, see: G.C.M. 6677, VIII-2 C.B. 172 (1926) as to Illinois; *Carpenter* v. *Com.*, 27 B.T.A. 282 (1932) as to Illinois: I.T. 3875, 1946-1 C.B. 98 as to Minnesota; I.T. 3754, 1945 C.B. 143 as to Wisconsin. As to the basis of tenancy by the entirety, see: *Lang* v. *Com.*, 289 U.S. 109, 12 AFTR 459 (1933); *Schiesser* v. *Com.*, 28 B.T.A. 640 (1933), Pennsylvania.

Conclusion. It can be seen from the above discussion that the taxpayer, by choosing the method of taking title to his residence, may govern the basis of such property when it is sold in the future. If the property is acquired when the market is low, it may be preferable for the spouse contributing the purchase price to take the title in his own name, or, in community property states, to take title as community property rather than taking it in the joint names of the spouses. In this way, upon death of one spouse, the surviving spouse gets a new basis and may save considerable income tax if it is desired to sell the property later. Vice versa, if the property is acquired in an inflationary market, as at present, and it is believed that the property will later decline in value, title may be taken in joint names. It may be noted that people will generally not acquire property for a high price if they think it will decline in value at a later date, and most taxpayers will prefer to take title in their own name if cognizant of the tax consequences.

6. Methods of Reporting Recognized Gain on the Sale of a Residence—How Should the Gain be Reported?

The time for reporting the recognized gain from the sale of a residence, and the amount of income reportable—unless the taxpayer elects to report the income under the Instalment Method and is able to meet the requirements of the Code and Regulations—depends upon whether the taxpayer is on the accrual or the cash basis. Ultimately the same profit will be reportable if all the selling price is received. On the accrual basis, the gain from the sale is taxable in the year the contract is executed rather than the year in which the payments are received. On the cash basis, the gain is taxable in the year when the amount received exceeds the basis of the property.[46] In the latter case, notes or other obligations received from the buyer are included in the amount received at their fair market value. This will be discussed more fully under Deferred Payment Sales Not on the Instalment Plan.

Instalment method. The Code[47] provides a special method for reporting the sale of real estate, which the taxpayer may elect as to each property sold if he can meet the provisions specified. Even though the same conditions exist in two or more sales of property this election may be made on one sale and not on the others.[48] This election must be made on the original return filed and cannot be secured by filing an amended return.[49] This method is known as the Instalment Method.

In order to qualify for the Instalment Method, the taxpayer must not receive more than 30 per cent of the selling price during the year that the sale of the real estate is made. This 30 per cent is known as the initial payment. It includes not only the down payment but all payments made during the year of sale.[50] The Regulations provide that there must be at least one payment during the year of sale in order to qualify for the Instalment Method; if no payment is made in that year but the entire purchase price is to be paid in a later year, this method may not be used.[51] This has been corrected by the 1954 Code so that in sales made after December 31, 1953 it will qualify as an instalment sale if no payments are received in the year of sale. The initial payment does not include the contract of the purchaser nor any indebtedness against the property, whether the purchaser assumes the indebtedness or merely takes the property subject to the indebtedness. However, if the indebtedness exceeds the basis of the property, then this excess is considered as part of the initial payment.[52] If the seller should dispose of any of the notes of the purchaser to a third party during the year of sale, provided they are due and payable in a subsequent year, this is not considered as part of the initial payment and the seller may still qualify for the Instalment Method. It does not include any of the charges included in the escrow statement, such as taxes, insurance, etc., which the buyer agrees to pay.[53]

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[46] *Helvering* v. *Nibley Mimnaugh Lumber Co.* (C.A. of D. of C. 1934), 70 F. 2d 843, 14 AFTR 209; *Com.* v. *Union Pacific Railroad Co.* (C.A. 2, 1936), 86 F. 2d 637, 18 AFTR 636.

[47] 1954 IRC § 453; 1939 IRC § 44(b). For rules, see Reg. 118, § 39.44-3. Wherever not otherwise indicated, the rules are in this section of the Regulations.

[48] G.C.M. 3350, VII-1 C.B. 62.

[49] *Pacific National Co.* v. *Welch,* 304 U.S. 191, 20 AFTR 1248 (1938).

The selling price includes not only the amount of cash or other property which the purchaser agrees to pay for the property but also any indebtedness against the property sold, whether the purchaser takes the property subject to the indebtedness or assumes the indebtedness. The amount of commissions and other selling expenses paid or incurred by the seller are not to be deducted or taken into account in determining the amount of the initial payments, the selling price, or the total contract price.

The fact that there is no provision for the balance to be paid in instalments is not conclusive as to the use of the Instalment Method but the fact that in the year of sale the initial payments received do not exceed 30 per cent of the selling price.[54] If there are only two payments to be made, one in the year of sale and the balance in the following year, the Instalment Method may be used.[55] Thus it can be seen that the seller, if he chooses, may arrange the payments in such a way that not more than 30 per cent of the selling price of the property is received in the year of sale, with subsequent payments to be made in later years, so as to spread the reporting of the gain and thus get into a lower bracket. If the taxpayer is in a high tax bracket anyway, there is no advantage to this method as the maximum tax on capital gains is 25 per cent of the recognized gain.

The writer has found many situations where taxpayers, or their tax advisers, have used the Instalment Method as a matter of course only to find upon analysis that this was ill advised as it shifted income into years of higher tax brackets. A good deal of thought should be given to the prospective future income before deciding to use this method. In many cases the taxpayer would rather receive his money immediately, while the buyer has the means of paying, rather than take a chance on default of payments in the future with the possibility of litigation in an attempt to collect payments and eventual actual realization of much less on the sale. If the sale is made towards the end of the year, however, the taxpayer may arrange to collect 30 per cent of the selling price at that time and the balance the following year. The Instalment Method applies only to gains and not to losses.[56]

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[50] *Sweet* v. *Com.*, 8 B.T.A. 404 (Acq.) (1927); *Einig* v. *Com.*, 19 B.T.A. 1105 (1930); O.D. 569, 3 C.B. 108.

[51] In *Newaygo Portland Cement Co.* v. *Com.*, 27 B.T.A. 1097 (Acq.) (1933), the vendor entered into a contract of sale in 1922 but the sale was not to be consummated until 1923. Ten per cent of the selling price was paid in 1922 and the balance in 1923. The Board held that the Instalment Method could not be used but the entire gain must be reported in 1923 when the sale was consummated.

[52] *Burnet* v. *Sand L. Building Corp.*, 286 U.S. 406, 12 AFTR 15 (1932).

[53] *Watson* v. *Com.*, 20 B.T.A. 270 (1930).

[54] I.T. 2691, XII-1 C.B. 52.

[55] G.C.M. 12148, XII-2 C.B. 57.

How income is reported under the instalment method. The home owner who sells his residence and has a gain to report should first determine his reportable gain in the regular way. If no new residence is to be acquired in the statutory period, he would determine his gain by taking the difference between the total selling price, which, as stated before, would include any mortgages against the property whether assumed by the buyer or taken subject to the mortgage, and his adjusted basis of the property, and would then subtract the brokerage commissions and other selling expenses. If a new residence is acquired, as discussed previously, the reportable gain is limited to the excess of the amount received for the old residence over the cost of the new residence.

The next step is to determine the contract price, which is the amount which the purchaser agrees to pay to the buyer in instalments. This is the total selling price less the indebtedness against the property, not in excess of the basis of the property, and includes the initial payment. The per cent of profit reportable to the contract price is then computed. This percentage is then applied to the payments on the contract received during the year.

Example: In 1935, a taxpayer acquired a house for $8,000, which he used as his principal residence. Subsequent improvements were made to the house at a cost of $2,000. In 1954 he sold the house for $20,000, paying a commission to the broker of $1,000. The buyer paid $2,000 down and $1,000 more in 1954, and assumed a mortgage against the property in the amount of $11,000. The balance was paid in January, 1955. In December, 1954 the taxpayer acquired a new residence at a cost of $16,000.

Selling price		$20,000
Less: Basis of old residence	$10,000	
Sales commission	1,000	11,000
Gain on sale		$ 9,000
Gain recognized is limited to $20,000—$1,000—$16,000 or		$ 3,000
Initial payment		
Down payment		$ 2,000
Other payments in 1954		1,000
Excess mortgage over basis		1,000
Total initial payment		$ 4,000

Since $4,000 is less than 30 per cent of $20,000, the Instalment Method may be used.

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[56] *Martin* v. *Com.* (2 Cir. 1932), 61 F. 2d 942, 11 AFTR 1019, cert. den. 289 U.S. 737.

Contract price	
Selling price	$20,000
Less: Mortgage assumed (not in excess of basis)	10,000
Contract price	$10,000
Per cent of recognized gain to contract price	30%
Gain reportable in 1954—30% of $4,000, or	$ 1,200
Collected in 1955	$ 6,000
Gain reportable in 1955—30% of $6,000, or	$ 1,800

If the $6,000 was to be paid over a period of years, the same principles would apply, and the taxpayer would report 30 per cent of the amount collected in later years.

Disposition of instalment obligations.[57] We will assume in the foregoing example that the seller received six notes of $1,000 payable one each year with interest at 6 per cent. In 1952 he needed additional money to purchase his new residence and he discounted three of these notes at the bank for $2,800. Since 30 per cent of $20,000 is $6,000, would this disqualify the seller from using the Instalment Method? It has been held that it would not,[58] and he may still use the Instalment Method, but he must report an additional gain in 1952 on the disposition of these instalment notes.

The Code provides[59] that if an instalment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) in the case of satisfaction at other than face value or a sale or exchange—the amount realized, or (2) in the case of a distribution, transmission, or disposition otherwise than by sale or exchange—the fair market value of the obligation at the time of such distribution, transmission, or disposition. Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the instalment obligation was received. The basis of the obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full. Since the Code states that the gain or loss on disposition of the obligation shall be considered as resulting from the disposition of the property itself, it has been held that the holding period of the instalment obligations is determined by the length of time the property disposed of was held, and that the length of time the obligations were held is not added.[60]

The result of this Code provision is that, if the seller of a residence should die before all the payments on the obligations are received, the balance of the profit would be reportable on the tax return of the decedent for the year of his death, but not in excess of the fair market value of the unpaid obligations at that time. The 1939 Code (Sec. 44(d)) provided, however, that, if a bond was filed with the Commissioner conditioned upon the return of income by the beneficiary of the same amounts that would be returned by the decedent, this unrecovered profit need not be reported on the tax return of the decedent. The Regulations provide that this bond shall be filed on Form 132 in an amount, subject to approval by the Commissioner, sufficient in his judgment to insure the collection of the tax resulting from the fulfillment of the conditions stated in the bond. This should be filed at the time of filing the decedent's return for the year of his death, or at such later time as may be specified by the Commissioner. In lieu of such bond there may be deposited bonds or notes of the United States. Under Section 691 (d) of the 1954 Code this necessity of a bond is eliminated and instalment sales are treated as income in respect of the decedent. The estate tax attributable to the item is an allowable deduction for income tax purposes.

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[57] 1954 IRC § 453(d); 1939 IRC § 44(d); and Reg. 118, § 39.44-5.

[58] *Robinson* v. *Com.* (9 Cir. 1934), 73 F. 2d 769, 14 AFTR 758; G.C.M. 12987, XIII-1 C.B. 206; I.T. 2776, XIII-1 C.B. 207.

[59] See Note 57, above.

[60] *Rogers* v. *Com.* (2 Cir. 1944), 143 F. 2d 695, 14 AFTR 1049, cert. den. 323 U.S. 780.

Repossession of property sold using instalment method. Suppose that a residence is sold and the taxpayer elects to report under the instalment method and, at a later date, before all the profit has been reported, there is a default in the payment on the obligations and the seller is forced to take back the property. What happens to the unreported profit? The regulations[61] provide that, whether title was retained by the seller or was transferred to the buyer, the property taken back will be considered as a payment on the obligations equal to the fair market value of the property so reacquired, including any improvements made by the purchaser. If the property is bid in by the seller at a foreclosure sale, then this fair market value shall be presumed to be the bid-in price, and this can only be overcome by clear and convincing proof to the contrary. Suppose, further, that at the time of taking back the property its fair market value does not equal the amount of the unpaid obligations, what happens to this balance? If there is a deficiency judgment, or if the purchaser is unable to pay this balance, there may be claimed a bad debt loss at the time it became worthless equal to the difference between the face amount of the unsatisfied obligations and the unreported profit thereon.

Deferred payment sales not on the instalment plan. The Regulations[62] provide for the reporting of income on the sale of property where the initial payment is in excess of 30 per cent and thus the instalment method cannot be used. In such a case the obligations received shall be considered as cash equal to their fair market value. This would arise in a case where the property is sold for cash plus a note for the balance or where there is a first mortgage against the property and the seller receives notes for the difference between the selling price of the property and this first mortgage and cash or other property. This second mortgage or other obligation may not be worth its face value. It would then be considered as cash at an amount equal to the sum for which it could be discounted at a bank, or otherwise disposed of. No gain will be reportable until the amount received, including the fair market value of the obligations, exceeds the adjusted basis of the property; then the profit is reportable as the collections are made. The regulations state that "Only in rare and extraordinary cases does property have no fair market value."

Repossession of property where this method is used.[63] This will depend upon whether at the time of sale (1) the title was retained by the seller, or (2) the seller had previously transferred title to the buyer.

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[61] Reg. 118, § 39.44-3.
[62] Reg. 118, § 39.44-4.
[63] *Ibid.*

If title was retained by the seller, then the seller must return as income, upon repossession of the property, the difference between (1) the sum of the entire amounts actually received on the contract and retained by the seller plus the fair market value at the time of repossession of the improvements placed on the property by the purchaser, and (2) the sum of the profits previously returned as income in connection therewith and the depreciation which would have occurred during the period the property was in the hands of the purchaser. The basis of the repossessed property in the hands of the seller is then the original basis before the sale of the property plus the fair market value at the time of repossession of the fixed improvements placed on the property by the purchaser.

If the seller had previously transferred the title to the purchaser and the vendor accepted a voluntary reconveyance of the property in partial or full satisfaction of the unpaid portion of the purchase price, then the fair market value of the property received, including the fair market value of the improvements placed on the property by the purchaser, is considered as a receipt in payment on the obligations satisfied. If this fair market value is in excess of the basis of the obligations satisfied, this excess constitutes ordinary income. If it is less, then the difference may be deducted as a bad debt if uncollectable. The new basis of the property is this fair market value. If this property was sold at a foreclosure sale[64] and the proceeds were less than the amount of the debt, and the balance is uncollectable, this difference may be claimed as a bad debt. If, on the other hand, the seller buys in the property at the sale, there is a gain or loss measured by the difference between the amount of the obligations applied and the fair market value of the property. The fair market value of the property is presumed to be the amount for which it is bid in, and this presumption may only be overcome by clear and convincing evidence to the contrary. The new basis of this property is this fair market value.

7. Conclusion

It may be seen from the foregoing discussion that a taxpayer either acquiring or selling a residence has many choices and should consider the tax consequences before he makes a move. The average taxpayer does not acquire many principal residences during his lifetime and he is generally not as interested in getting a stepped-up basis as he might be when acquiring property for investment or for use in his business since he is not getting any depreciation deduction upon the residential property.

When a taxpayer acquires a residence he should consider how title should be taken. As previously noted, many people automatically take the title in joint tenancy or other similar method with their spouse, hoping to avoid probate upon the death of one of the spouses. The tax consequences would not make this a wise choice. Of course this has been partially corrected by the new Code.

When the residence is sold there should be proper timing so as to take advantage of the non-recognition of gain by the acquisition of a new residence within the statutory time. If the taxpayer feels that he will need more time within which to acquire a new residence, he may enter into a contract of sale whereby the sale will not take place until a later date. He also may try to speed up the date of acquisition of a new residence in his dealings with the seller.

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[64] Reg. 118, § 39.23(k)-3.

Also, the taxpayer has a choice of methods in reporting income. He may desire to spread his profit over more than one year. To do this he should see that not more than 30 per cent of the selling price is received in the year of sale. With lower tax rates on capital gains, the writer believes that in many cases it is better to receive the consideration for the sale while the buyer is able to pay rather than to spread the reporting of income over a long period of time, taking an instalment note, and thus taking a chance of not receiving the entire consideration. If the taxpayer receives more than 30 per cent of the selling price in the year of sale, he should proceed to determine the fair market value of the instalment notes so as to defer payment of tax on the gain until it is determined that all the notes are paid. This may be done by inquiring of his banker or other parties the amount they would be willing to pay for the notes.

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Federal Income Tax on Assignments of Interests in Oil and Gas

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1. Points to Consider

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In the field of oil and gas investments, the making of particular types of sales and purchases involves principally the forms of assignment of interest from the lessee to the investor. While the investor in oil and gas may sometimes be involved in the leasing transaction itself, through the acquisition of either a fee interest in the land or royalty, as well as in the acquisition of a working interest, generally the outside investor comes into an oil transaction through some form of deal made with the lessee by way of assignment of a portion of the lessee's interest. These assignments by the lessee generally take one of four different forms, or a combination of them. The assignment may take the form of a farm-out, either by way of an overriding royalty or a limited overriding royalty, otherwise known as an oil payment, or it may take the form of a carried interest or a net profits interest.

While assignments from the lessee may be broken down into the four forms of assignment mentioned, nevertheless, in practice oil deals are as numerous and unique as the mind of man can devise. In fact, the secret of the very existence of the independent oil man lies very largely in the ingenuity which he has through the years exercised in setting up deals which would attract the investor and thereby enable the oil man to get a well drilled or to get a lease developed when he himself did not have sufficient funds to do it alone. In the oil business it has always been deemed good practice to share the risk, and with that sharing has gone a sharing of profits.

In making an oil deal involving the assignment of a portion of the lease interest to an investor it is necessary that both parties to the transaction bear in mind, in addition to all of the geological and geophysical factors in finding the oil and getting it to the surface, a number of important tax factors, all of which may play an important role in determining the final form of the assignment. These five principal tax factors are the following: (1) depletion, either on the basis of cost or percentage depletion at a rate of 27½ per cent, (2) the intangible drilling deductions, (3) the depreciation deductions for physical equipment, (4) whether the taxpayer involved will receive his profits in the form of capital gain or ordinary income, and, if the latter, whether the ordinary income will be subject to depletion or not, (5) whether the particular taxpayer will receive the benefit of a loss deduction if the drilling operation is unsuccessful.

The tax treatment of the independent oil man has been attacked as unfair to taxpayers engaged in other types of business.[1]

Without going into an extended discussion of the merits or demerits of the tax treatment accorded the independent oil producer and the investor in oil properties, it would appear worthwhile to point out that the industry average indicates that only one out of ten wildcats will ordinarily result in a discovery, and of the discovery wells only about one in five will make a decent field. It does not take much experience in the oil business to teach an investor that merely bringing in a producer is not the whole story. Many a producer is brought in to flow but a day, and certainly in many cases a weak producer is less to be desired than a dry hole, since at least in the case of a dry hole the investor may charge off his loss, for whatever benefit that is worth.

Certainly it is important for the investor in an oil deal to make sure of many things before committing himself on his investment. In addition to making certain that he has capable and honest management with respect to the oil property, it is also important that he make the deal upon terms which are as favorable to him as possible. In this respect he is much like a golfer going to the first tee where he is to decide on what basis the match will be played and how many strokes his opponent will give him, or vice versa. In many cases he can lose the match right there. Similarly, an investor entering into an oil deal may enter into a deal which is too heavily loaded against him, either from an investment standpoint or from the standpoint of the tax burdens upon him. The investor at such point must bear in mind his own capacities to handle the responsibilities of the deal, and he must have a knowledge of what the effect will be either in the event of a producer or in the event of a dry hole. Having set up a deal on the most favorable terms to himself, he thereby reduces the gamble which exists whenever anyone drills a hole in the ground hoping to bring up oil.

Perhaps the greatest area of confusion in the tax law relating to oil and gas is that which exists with respect to assignments of interest in the lease. It is there that the investor must focus most of his attention, and for that reason the more accurate his grasp of all the tax factors involved with respect to assignments of oil and gas leases the greater the reduction of errors which the investor may make in entering upon an oil deal and the smaller will be his gamble, although there are always risks in any oil drilling deal.

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[1] Walter J. Blum, "How to Get All (But All) the Tax Advantages of Dabbling in Oil," *Taxes, The Tax Magazine,* May, 1953, Vol. 31, page 343; for additional arguments pro and con, see; Rex G. Baker and Erwin N. Griswold, "Percentage Depletion—A Correspondence," *Harvard Law Review,* January, 1951, Vol. 64, page 361; George E. Ray, "The Attack on Percentage Depletion," *Second Annual Institute on Oil and Gas Law and Taxation, Southwestern Legal Foundation,* page 531. New York: Matthew Bender and Company, 1951.

2. Overriding Royalties

Overriding royalties are one of the two types of "farm-outs." In the case of an overriding royalty the lessee ordinarily assigns his lease for cash and retains an overriding royalty of some fraction, such as one-eighth, in the oil and gas in place. The assignee receives the balance of the working interest, after having deducted from the original eight-eighths of the oil and gas the one-eighth royalty of the lessor and the additional fraction retained by the lessee in his assignment. The assignee, as holder of the working interest, then has the burden of drilling and developing the lease. The cash received by the assignor is treated by him as ordinary income subject to depletion even though the transaction may be treated as a sale under local law.[2] For tax purposes the assignor treats the transaction as a sub-lease and he is in essentially the same position as the original lessor. The assignor is in the same position with respect to his overriding royalty as the original lessor is with respect to his royalty and the income derived by the assignee from the overriding royalty is ordinary income subject to depletion.[3] The assignee is in the same position with respect to his working interest as the original lessee. The income which he derives from his working interest will be subject to depletion. The assignee may charge to expense his cost of operations, including intangible drilling and development expenses, in the event that he has elected not to capitalize these expenditures. He is also entitled to depreciation on the physical equipment on the property since it belongs to him as assignee of the lease. The depreciated cost of the equipment is thereby recovered by the assignor out of any cash payment received by him and the balance of his cost will be treated as ordinary income subject to depletion.[4]

The overriding royalty situation above outlined is commonly called the "*Palmer* v. *Bender*" type of assignment, for the leading Supreme Court decision outlining the tax treatment of such an assignment.[5]

The Treasury has held that in the event that the basis of the physical equipment exceeds the cash received by the assignor, the loss resulting is not deductible by the assignor and that the excess should merely be added to the basis of the retained depletable interest of the assignor.[6] The validity of the Treasury's position in light of the Supreme Court's later decision in the *Choate* case,[7] however, would appear open to considerable doubt. The Supreme Court in the *Choate* case made very clear that depreciation and depletion rest upon completely different bases and should not be confused by treating them as though they were different aspects of the same thing. Moreover, since the transaction is closed for purposes of computing gain, it would seem that it should be closed for the computing of loss as well.[8]

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[2] *West Production Co.* v. *Commissioner* (5 Cir. 1941), 121 F. 2d 783, 27 AFTR 618.

[3] *Palmer* v. *Bender*, 287 U.S. 551, 11 AFTR 1106 (1932); *Cullen* v. *Commissioner* (5 Cir. 1941), 118 F. 2d. 651; 26 AFTR 887; *Hogan* v. *Commissioner* (5 Cir. 1944), 141 F. 2d. 92, 32 AFTR 246, cert. den. 323 U.S. 710 (1944).

[4] Reg. 111, § 29.23(m)-16; *Choate* v. *Commissioner*, 324 U.S. 1, 33 AFTR 297 (1945).

[5] *Palmer* v. *Bender*, footnote 3, above.

[6] G.C.M. 23623, 1943 C.B. 313.

[7] Footnote 4, above.

In the case of an assignment of an overriding royalty interest the assignee, to the extent of the cash bonus paid by him to the assignor, has made a capital investment in the working interest acquired by him and he may use the amount of the cash bonus as his basis for cost depletion purposes.

As in the case of ordinary royalty, the proceeds received by the owner of an overriding royalty interest from production are considered to be the owner's share of the proceeds from the extraction and sale of oil and gas in place, and are not considered rent.[9]

In some cases it may be desirable for the assignor of an overriding royalty interest to take the cash bonus payments in installments over a period of several years rather than one year, since in some cases this will result in less tax on the cash bonus than if the bonus were all received and taxed in one year. In such case it is essential that the payments not be received in the form of a negotiable note since the note would be treated as the equivalent of cash to the extent of its fair market value. If, however, the obligation of the assignee is not negotiable the installments will be taxed only when received.[10] In such case the assignor may later sell his right to receive the installment bonus payments and since such right constitutes an economic interest in oil and gas in place, it is a capital asset, the sale of which entitles the seller to the preferential capital gain treatment on the sale of such right.[11]

In view of the fact that the cash bonus payable by the assignee for an overriding royalty must be capitalized by him and therefore recovered only through cost depletion, it is desirable for the assignee to hold such cash payments to a minimum since he will ordinarily use percentage depletion rather than cost depletion and the cash payment would not increase the assignee's percentage depletion allowance.[12]

Where the owner of the working interest, instead of retaining an overriding royalty, merely transfers the working interest for cash, then a sale, as distinguished from a sub-lease, takes place and no depletion would be allowable on the proceeds from the sale. The leasehold interest in such case would qualify for capital gain treatment under Section 1231 of the 1954 Internal Revenue Code if the other provisions of that section are met, and if the sale results in a loss the seller may be entitled to deduct it as an ordinary loss.[13]

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[8] Frank B. Appleman, "Sales and Assignments of Leases and Other Interests in Oil and Gas," *First Annual Institute on Oil and Gas Law, Southwestern Legal Foundation*, pages 442-443. New York: Matthew Bender and Company, 1949.

[9] G.C.M. 22730, 1941-1 C.B. 214.

[10] *Alice G. K. Kleberg*, 43 B.T.A. 277 (1941); *Alice G. K. Kleberg*, 2 T.C. 1024 (1943).

[11] R. B. *Cowden*, par. 50,304, Prentice-Hall Memorandum T.C. (1950), remanded for settlement, *Commissioner* v. *Cowden* (5 Cir. 1953), 202 F. 2d 748.

[12] John Paul Jackson, "Tax Planning Before Drilling: The Operator's Problem," *Tulane Law Review*, December, 1952, Vol. 27, page 34.

[13] Appleman, *op. cit.*, footnote 8, above.

3. Oil Payments

a. The nature of oil payments. The holder of an oil payment is entitled to receive oil and gas produced or the proceeds derived from an agreed share of production if, as and when produced, until a fixed or determinable amount of oil or gas or an ascertainable sum of money has been received.[14] An oil payment is "an economic interest in oil in place" since the holder of the oil payment is the owner of a share of the gross income derived from and based upon production. Consequently, the holder of the oil payment is entitled to depletion on the income which he receives from the oil payment.[15] Oil payments are, in fact, the same as overriding royalties except that they are limited either in terms of barrels of oil, thousands of feet of cubic gas, or in dollars. Oil payments are sometimes referred to as "production" payments. The oil payment may become payable when production is first obtained on a leasehold, or it may, in some cases, not become payable until the operator has recovered a fixed sum from production.[16] The oil payment may also be paid from a particular percentage of the oil produced bearing a pro rata share of the expenses of production.[17]

An important distinction between a retained overriding royalty and an oil payment arises where a cash payment accompanies the oil payment. In the case of the overriding royalty, the cash received with the overriding royalty is treated as ordinary income subject to depletion, whereas cash received with a retained oil payment is treated as purchase money received on the sale of a capital asset, entitled to capital gain treatment but not to depletion deduction.[18] The owner of an oil lease who wishes to assign it for cash plus an overriding royalty or oil payment is in a position to decide whether he would prefer to have an overriding royalty which will be subject to tax as ordinary income less depletion allowance, or to retain an oil payment which will make the transaction subject to capital gain treatment but without depletion allowance. This distinction between the two types of interest has been criticized as unjustifiable for the reason that the transactions may be identical.[19] The only real difference between the overriding royalty and the oil payment is that the oil payment is limited in amount. It may turn out, in some instances, that the oil payment will, in fact, be in an amount which never docs actually pay out, and in that event the oil payment would be the complete equivalent of the overriding royalty. Where taxpayers have deliberately set the oil payment at a figure which cannot on any reasonable basis be justified in light of the future production estimates with respect to the property involved, the Bureau has, in unpublished cases, taken the position that the reservation of the oil payment will in such cases be considered to be an overriding royalty rather than an oil payment and the transaction in such case is treated as a sub-lease rather than a sale.

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[14] G.C.M. 24849, 1946-1 C.B. 66.

[15] *Thomas* v. *Perkins,* 301 U.S. 655 (1937), 19 AFTR 538; *Anderson* v. *Helvering,* 310 U.S. 404, 24 AFTR 967 (1940); *Palmer* v. *Bender,* 287 U.S. 551, 11 AFTR 1106 (1932).

[16] *Jones* v. *Commissioner* (5 Cir. 1936), 82 F. 2d 329, 17 AFTR 633.

[17] *Commissioner* v. *Caldwell Oil Corp.* (5 Cir. 1944), 141 F. 2d 559, 32 AFTR 434.

[18] *Commissioner* v. *Fleming* (5 Cir. 1936), 82 F. 2d 324, 17 AFTR 628; *Hammonds* v. *Commissioner* (10 Cir. 1939), 106 F. 2d 420, 23 AFTR 379; *Columbia Oil & Gas Co.* v. *Commissioner* (5 Cir. 1941), 118 F. 2d 459, 26 AFTR 715; *Hogan* v. *Commissioner* (5 Cir. 1944), 141 F. 2d 92, 32 AFTR 246.

[19] J. Paul Jackson, "Federal Income Tax Problems Involved in Typical Oil and Gas Transactions in Texas," *Texas Law Review,* April, 1947, Vol. 25, page 355, holding that both transactions should be treated as sales.

In many cases operators of oil properties will give oil payments to drilling contractors or supply houses in exchange for the drilling of wells and for the equipment in connection therewith. In such case the transaction is not a taxable one, but rather a pooling or sharing transaction. The transaction enables the operator to avoid borrowing in order to get his lease drilled, but he loses his right to the intangible drilling deduction and the depreciation on the physical equipment. The drilling contractor or supply house in such case will treat the cost of drilling or of the supplies as a capital investment on which they will be entitled to cost depletion against the income derived from the oil payment. The lease operator in assigning the oil payment will lose the benefit of the percentage depletion deduction on the income which is paid to the holder of the oil payment, whereas if he were to borrow money to drill the well himself the income derived from the production would be subject to percentage depletion and he would, in addition, be entitled to his intangible drilling deduction and deduction for depreciation on equipment. In some cases, the operator's inability to obtain a sufficiently long term on his borrowings to enable him to repay the loan from production during such period may require him to make arrangements for drilling through the oil payment route despite the disadvantages to him taxwise.[20]

Where an investor purchases an oil payment merely for cash, the purchaser will ordinarily pay a price which will be high enough to warrant using cost depletion rather than percentage depletion. In such case the purchaser will compute cost depletion each year by multiplying his cost of the oil payment by a factor obtained by dividing his receipts for the year from the oil payment by the total amount expected to be received. If the purchaser takes percentage depletion instead of cost depletion, then he must reduce his gross receipts from the oil payment by a pro rata portion of the amount which he paid for the oil payment in order to determine depletable gross income. This is necessary in order to avoid allocating percentage depletion on an amount in excess of the total income from production on the property. Consequently, percentage depletion on an oil payment will exceed cost depletion only when the cost of the oil payment is less than 21.6 per cent of the aggregate gross proceeds from the oil payment. This is the "break-even" point.[21]

b. Retained oil payments. The Bureau of Internal Revenue has drawn a definite distinction between the tax treatment of an oil payment which is retained by the holder of a working interest when he transfers his working interest to someone and an oil payment which is "carved out" of a working interest, which working interest the assignor retains himself. In the case of the "retained" oil payment the transaction is one resulting in capital gain or loss.[22] In the case of the "carved-out" oil payment, the transaction is one which results in ordinary income to the assignor.[23]

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[20] See Jackson, *op. cit.*, footnote 12, above, pages 27-30.

[21] Arthur Andersen & Co., *Oil and Gas Federal Income Tax Manual*, 7th Edition, 1953, page 96.

[22] *Commissioner* v. *Fleming*, footnote 18, above; G.C.M. 22730, 1941-1 C.B. 214.

1. Where an oil payment alone is retained. Where the lessee of an oil property assigns an interest in the lease for cash and retains an oil payment for himself, but does not retain an overriding royalty interest in addition to the oil payment, the transaction is treated as a sale.[24] This type of assignment is often referred to as a "Fleming" type of assignment.

The retained oil payment is subject to depletion in the hands of the assignor since it is an economic interest in oil and gas in place.[25] In such a transaction the lessee will compute his gain arising from the receipt of the cash by allocating his basis in the leasehold between the part sold and the part retained under the oil payment on the basis of their respective fair market values.[26] To the extent that depreciable property is transferred with the lease, and in the absence of a provision in the contract of sale to the contrary, the cash received by the assignor should first be allocated to the depreciable property and the remaining balance, if any, should be treated as proceeds from the sale of the assignor's oil rights.[27] Where the cash consideration is less than the basis of the depreciable properties, the Bureau will deny the loss deduction as in the similar case involved in a transfer of the lease with an overriding royalty retained.[28]

The oil payment is of great assistance in disposing of producing oil properties in many cases, particularly in periods when purchasers of oil properties are short of cash. For example, if an operator owning a property with reserves of two million barrels worth approximately $1.00 per barrel in the ground wishes to sell his property for $2 million, its fair market value, he may have trouble finding a purchaser who has $2 million to pay when it may take the purchaser ten years or more to recover his $2 million from the production. On the other hand, the seller might well be able to sell the working interest in the property for $500,000, retaining an oil payment for the balance of $1,500,000 plus 6 per cent on declining balances to come from 75 per cent of the gross proceeds of production allocable to the seven-eighths working interest. The purchaser of the oil payment might borrow the $1,500,000 from a bank or insurance company at 5 per cent interest, pledging the oil payment as collateral.

In the above case the seller of the working interest would realize capital gain on the sale of the working interest. If the working interest were sold first and to someone completely unrelated in any way to the purchaser of the oil payment, then the sale of the oil payment as well as the sale of the working interest would result in capital gain to the seller. It would be important, however, for the seller to make sure that there was no tie between the purchaser of the working interest and the purchaser of the oil payment, and also to make sure that the sale of the oil payment did not take place prior to the sale of the working interest, since if the oil payment were sold first then it could be held to be the sale of a "carved-out" oil payment with ordinary income resulting to the seller.[29] It has been argued that if the sale of the oil payment and the sale of the working interest occur at the same time, but to different parties, then the seller would nevertheless be entitled to capital gain treatment if the seller in the simultaneous transactions disposed of all of his property.[30]

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[23] G.C.M. 24849, 1946-1 C.B. 66.

[24] *Commissioner* v. *Fleming,* footnote 18, above; *Laird* v. *Commissioner* (5 Cir. 1938), 97 F. 2d 730, 21 AFTR 574; *Hammonds* v. *Commissioner,* footnote 18, above; *Cullen* v. *Commissioner,* footnote 3, above; *McLean* v. *Commissioner* (5 Cir. 1941), 120 F. 2d. 942, 27 AFTR 544, cert. den. 314 U.S. 670 (1941).

[25] *Lee* v. *Commissioner* (5 Cir. 1942), 126 F. 2d. 825, 28 AFTR 1520.

[26] *Columbia Oil and Gas Co.* v. *Commissioner* (5 Cir. 1941), 118 F. 2d. 459, 26 AFTR 715; *American Liberty Oil Co.* v. *Commissioner* (5 Cir. 1942), 127 F. 2d. 262, 29 AFTR 245.

[27] *Thomas* v. *Peckham Oil Co.* (5 Cir. 1940), 115 F. 2d 685, 25 AFTR 1055.

[28] G.C.M. 23623, 1943 C.B. 313.

2. *Where an oil payment and overriding royalty are both retained.* In some cases the assignment of the leasehold interest involves the retention by the assignor of both an oil payment and an overriding royalty. The question arises as to the nature of the transaction in such instance; that is, whether the transaction results in ordinary income or capital gain. It has been held that in such a case the cash received by the assignor is ordinary income subject to depletion.[31] Since the transaction takes its character from the overriding royalty rather than from the oil payment, the income received by the assignor from the overriding royalty and the oil payment constitute income to the assignor and are excluded from the assignee's income. In this respect the assignee is better off than as to the cash payment, since he does not get any deduction for the cash payment. Consequently, it may be better for the assignee to agree to the reservation of a larger oil payment and overriding royalty if he can, thereby reducing the amount of the cash payment required. On the other hand the assignor may be willing to give up the right to some cash in order to get a larger oil payment or overriding royalty which, if the property produces, may pay him a greater sum and the payments will be spread over several years rather than being paid in a single year.

Where the assignor reserves both an overriding royalty and an oil payment it might be said that, in fact, he has retained only a single interest consisting of an overriding royalty out of a varying fraction of the gross production.[32]

3. *Where no true oil payment is retained.* The holder of a true oil payment can look only to the production from the property to satisfy his oil payment. If, therefore, the transaction provides that if the production is insufficient to yield the designated sum of money or barrels of oil that the assignor then agrees to pay the difference between what the assignee received from the production and the designated amount to be paid, then there is not a true oil payment. The same is true if the agreement provides that the assignee may be satisfied out of a sale of the property itself, since in such case the designated amount is not payable solely out of production.[33] If, however, the amount in question is secured solely by a lien on the production, then a true oil payment is involved.[34] Where the payment is secured by a lien on the leasehold interest and equipment, it does not qualify as a true oil payment.[35] Similarly, if the oil payment is personally guaranteed by the assignee or the assignor is given some additional form of security over and

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[29] G.C.M. 24849, footnote 14, above.

[30] James T. Williams, II., "Assignment of Leasehold Royalty and Oil Payment," *Second Annual Institute on Oil and Gas Law and Taxation, Southwestern Legal Foundation,* page 510. New York: Matthew Bender and Company, 1951.

[31] *McLean* v. *Commissioner,* footnote 24, above; *Cullen* v. *Commissioner,* footnote 3, above.

[32] *Arthur Andersen & Co., op. cit.,* footnote 21, above, page 143.

[33] *Anderson* v. *Helvering,* footnote 15, above.

[34] *Hugh Hodges Drilling Co.,* 43 B.T.A. 1045 (1941); *E. C. Laster,* 43 B.T.A. 159 (1940).

[35] *Charles Burke,* 5 T.C. 1167 (1945).

above the production from his interest in the property, then a true oil payment does not exist. In such event the assignor will be denied depletion on the oil runs which he receives, although he may receive capital gain treatment as to both the cash bonus and such oil runs. The assignee, in such event, is charged with all of the income from the wells, including the share payable to the assignor, since the assignee is considered to be the owner of the entire lease and his guarantee is treated as the equivalent of purchase money. In the case of a true oil payment the amounts received by the assignor in satisfaction of his oil payment are excluded from the income of the assignee.

c. Carved-out oil payments. The Treasury, in a highly controversial ruling,[36] in 1946 held, contrary to a number of unpublished rulings, for the first time that an oil payment carved out of a larger economic interest in oil and gas in place resulted in ordinary income subject to depletion rather than capital gain, if the oil payment was a "short-lived" oil payment. The Treasury ruling conflicted with a number of decisions which had been handed down by the courts and in which it was indicated that the sale of a carved-out oil payment was the sale of a capital asset and any gain resulting therefrom was taxable as capital gain rather than ordinary income subject to depletion.[37] Not only did the Treasury ruling conflict with decided cases, it was difficult to reconcile with an earlier comprehensive ruling of the Treasury Department dealing with oil payments.[38] The Treasury ruling results in permitting a double depletion deduction with respect to the same oil payment, both to the assignor and to the assignee, but this result was deemed "immaterial" by the Treasury in the ruling, despite the long-standing principle enunciated by the Supreme Court that the owner of an interest in the deposit, while entitled to deduct for depletion of the part producing his income, could not deduct for the share belonging to another.[39] The Treasury's position does derive some support from cases dealing with the assignment of income between members of a family.[40] The most objectionable feature of the Treasury ruling was, however, its retroactive application. This, however, was later remedied by the Treasury so that the ruling would only have prospective application from the date of its issuance.[41]

The Treasury later decided to extend the ruling with respect to carved-out oil payments to assignments of short-lived oil payments which were not sold, but represented gifts, and held that the assignment by way of gift resulted in ordinary income subject to depletion to the donor of the oil payment.[42]

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[36] G.C.M. 24849, footnote 14, above.

[37] R. E. *Nail*, 27 BTA 33 (1932); *Majestic Oil Corporation*, 42 BTA 659 (1940); *Ortiz Oil Co.* v. *Commissioner* (5 Cir. 1939), 102 F. 2d. 508; 22 AFTR 908, cert. den. 308 U.S. 566 (1939); *Badger Oil Co.* v. *Commissioner* (5 Cir. 1941), 118 F. 2d. 791, 26 AFTR 910; see George E. Ray and Oliver W. Hammonds, "The Income Tax on Proceeds From the Sale of Oil Payments; The Validity of G.C.M. 24849," *Texas Law Review*, December 1946, Vol. 25, page 121; George E. Ray, "Problems of the Oil and Gas Industry: Assignment of In-Oil Payment Rights," *Proceedings of New York University Ninth Annual Institute on Federal Taxation*, page 505. New York: Matthew Bender & Co., 1951; Kenneth G. Miller, "Selling 'Oil Payment'," *Taxes, The Tax Magazine*, Vol. 27, page 188 (194 . See also G. W. Welsch, "Acquiring Properties Through Oil Payment and Related Methods," *Taxes, The Tax Magazine*, Vol. 32, page 494 (1954).

[38] G.C.M. 22730, footnote 9, above.

[39] *Thomas* v. *Perkins*, footnote 15, above.

[40] *Lucas* v. *Earl*, 281 U.S. 111 (1930), 8 AFTR 10287; *Helvering* v. *Horst*, 311 U.S. 112 (1940) 24 AFTR 1058; *Helvering* v. *Eubank*, 311 U.S. 122 (1940) 24 AFTR 1063.

[41] I.T. 3895, 1948-1 C.B. 39 (1948).

The Treasury finally recognized that the distinction which had been drawn in its earlier ruling between short-lived oil payments which resulted in ordinary income, and long-lived oil payments which resulted in capital gain or loss, was not a sound one, and held that the assignment of any carved-out oil payment which was not pledged for development and which extended over a period less than the life of the depletable interest from which it was carved out, resulted in ordinary income subject to depletion.[43] The reason assigned for the holding was that in such case the oil payment was essentially the assignment of expected income from the property interest. Further problems may arise in light of the Treasury's most recent ruling in determining the "life of the property." The Tax Court has consistently held in a number of recent cases that the sale of a carved-out oil payment results in capital gain, rather than ordinary income.[44]

Even if the oil payment be a "carved-out" oil payment, if the oil payment proceeds are pledged to the development of the property the Treasury has held that the payment of the proceeds does not result in taxable gain.[45]

It is an ill wind that blows no good, even in tax law, and there are cases where an oil operator may find it advantageous to carve out and sell an oil payment in order to increase his income in a year in which he has substantial drilling deductions, the benefit of which might otherwise be lost. By selling the oil payment the operator, in such case, anticipates income on which he need not pay any tax to the extent that his drilling deductions and losses off-set the amount of the income. The Treasury ruling also enables operators, in some cases, to level out their operations for successive years, carving out and selling oil payments in years in which the income would otherwise be less than normal. Moreover, where development costs of the operator are unusually great in a particular year, the operator may be able to save his right to percentage depletion by selling carved-out oil payments, since percentage depletion is limited to 50 per cent of net income, and if the development and other expenses of the operator exceed his gross income for that year, he would have no net income and would lose his percentage depletion on his production because of the limitation of percentage depletion to 50 per cent of net income.

4. Carried Interests

Carried interests, like other arrangements in the oil industry, take all kinds of forms and vary considerably in detail. For classification purposes they can be broken down in two ways: one, on the basis of their duration, between (1) those which last for the entire life of the leasehold operations and (2) those which last only for the initial development period; or, two, they may be classified into (1) those which involve a co-ownership between the carried and the carrying party and (2) those in which the carrying party has a reversionary interest.

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[42] I.T. 3995, 1949-1 C.B. 39 (1949).

[43] I.T. 4003, 1950-1 C.B. 10 (1950).

[44] *Lester A. Nordan*, 22 T.C. 1132 (1954), app. dism. 5 Cir. June 8, 1955; *John David Hawn*, 23 T.C. 516 (1954), app. pend.; *Wm. Fleming, et al.*, 24 T.C. No. 93 (1955); *A. J. Slagter, Jr.*, 24 T.C. No. 104 (1955); *Caldwell* v. *Campbell* (5 Cir. 1955), 218 F. 2d 567; *P. G. Lake, Inc.*, 24 T.C. No. 114 (1955); *W. F. Weed*, 24 T.C. No. 116 (1955). See Oliver W. Hammonds and George E. Ray, "Oil Payments Revisited: Current Income Tax Status of Oil Payments," *Taxes, The Tax Magazine*, Vol. 33, p. 349 (1955).

[45] G.C.M. 22730, footnote 9, above.

In the typical carried interest arrangement, A and B, owning undivided interests in an oil and gas lease, agree that B is to develop the lease at his own expense and to operate the property, to advance A's share of the funds necessary for development and operating expenses, to sell all of the oil produced and to credit A with one half of the proceeds until all advances have been fully paid, and thereafter to operate the property and pay one half of the proceeds from the sale of all oil produced, less one half of the operating expenses, to A. A has no personal liability to repay B for the amount advanced by B, B looking only to A's share of the production from the lease, if any, to repay the advances.

In a situation similar to the one above outlined it was held in *Reynolds* v. *McMurray*[46] that in such case B, who assumed all the risk and advanced all the money to pay the development and operating costs, was only entitled to take one half of the intangible charge-offs and one half of the depletion deductions, since A owned one half of the working interest. B was also considered to have received only one half of the income because he only owned one half of the production. A was held entitled to one half of the deductions for intangible drilling and development costs and one half of the depreciation, while being charged with one half of the income. The fact that A had no personal liability was deemed immaterial for the reason that he had, in effect, pledged his one half of the retained income to repay the amounts advanced in his behalf by B, and B had merely looked to such retained income for repayment of his advances.

Nine years later the Treasury Department, in G.C.M. 22730,[47] holding contrary to the Circuit Court in *Reynolds* v. *McMurray*, took the position that during the period in which B "carried" A the entire income was taxable to B and he alone was entitled during that period to the deductions for intangible drilling expenses and depreciation.

The Treasury view set forth in the G.C.M. was generally followed until the *Abercrombie* case[48] in which the Tax Court and the Fifth Circuit Court of Appeals reverted, in substance, to the rule set forth in *Reynolds* v. *McMurray*. The Tax Court in the *Manahan* case,[49] decided one month before the *Abercrombie* case, had held essentially in accord with the views set forth in G.C.M. 22730.

Two years later, in 1949, the Bureau published the *Abercrombie* decision and withdrew its non-acquiescence in the Tax Court's decision, thereby giving approval to the *Abercrombie* decision. In practice, however, the Bureau has consistently taken the position that unless the particular facts in the case are "on all fours" with those in the *Abercrombie* case, the G.C.M. rather than the *Abercrombie* decision will be followed.

The net result of the above conflict of decisions and rulings is to cast a cloud on the use of the carried interest arrangement. It has been suggested[50] that where the carried interest of A is of the "reversionary type" rather than the "co-ownership" type, the carried interest is more satisfactory to all parties, including the Bureau. In such case deductions will be allowed to B, who incurs the expenditures and assumes the risk, and all of the income will be taxed to him as the true recipient. In view of the Bureau's consistent practice of disregarding the *Abercrombie* case with respect to carried interest arrangements which are not based on virtually identical facts to those in the *Abercrombie* case, the use of a reversionary type of carried interest rather than the co-ownership type would, at least until the Treasury changes its views, appear to give the taxpayer reasonable safety in using a carried interest arrangement. It would be helpful toward this end if the Treasury Department would publish in some form a ruling reflecting its present position, particularly in light of the fact that the last published view of the Bureau, the acquiescence in the *Abercrombie* case, would tend to indicate that the Bureau was in agreement with that decision and would apply it to carried interests in general.

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[46] *Reynolds* v. *McMurray* (10 Cir. 1932), 60 F. 2d 843, 11 AFTR 840, cert. den. 287 U.S. 664; *Helvering* v. *Armstrong* (9 Cir. 1934), 69 F. 2d 370, 13 AFTR 695.

[47] Footnote 9, above.

[48] *Commissioner* v. *J. S. Abercrombie Co.* (5 Cir. 1947), 162 F. 2d 338, 35 AFTR 1467.

[49] *Manahan Oil Co.*, 8 T.C. 1159 (1947).

A safer course than using the reversionary type of carried interest has been resorted to by many taxpayers who have turned to the net profits interest in lieu of the carried interest arrangement.[51]

5. Net Profits Interests

In the typical net profits interest arrangement, the lessee transfers his entire interest in the property to the operator, reserving to himself a share in the net profits realized by the operator from the development and operation of the lease. The operator agrees to develop the properties and to pay all operating expenses.

In early cases dealing with the taxation of the net profits interest transactions, the Supreme Court held[52] that in the case of a net profits interest the assignor did not have an economic interest in oil and gas in place, and therefore was not entitled to depletion deduction on the amounts received by him under the net profits agreement. The assignee was taxed on all the income derived from the lease and he was entitled to deduct all the drilling and development expenses if he did not elect to capitalize them. He was not, however, permitted to deduct the amount of the net profits payments made to the assignor, since they were an additional cost paid for the lease and had to be capitalized.

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[50] John Paul Jackson, *op. cit.*, footnote 12, above, page 37.

[51] This course has been recommended in able discussions of the *Abercrombie* case by Sidney D. Krystal, "The Abercrombie Case: A Critique and Suggestion," *Southwestern Legal Foundation Institute on Federal Taxation.* New York: Matthew Bender and Company, 1950, page 155; Roger S. Randolph, "Problems of the Oil and Gas Industry: Depletion Problems Including Those Arising from the Hudson and Abercrombie Decisions," *New York University Ninth Annual Institute on Federal Taxation,* page 502. New York: Matthew Bender and Company, 1951. This general problem is also capably discussed in Frank B. Appleman, "Sales and Assignments of Leases and Other Interests in Oil and Gas," *First Annual Institute on Oil and Gas Law, Southwestern Legal Foundation,* page 464. New York: Matthew Bender and Company, 1949; Sam G. Winstead, "Carried Interests and Net Profits Interests," *Second Annual Institute on Oil and Gas Law and Taxation, Southwestern Legal Foundation,* page 517. New York: Matthew Bender and Company, 1951; J. Paul Jackson, footnote 19, above, page 367; Arthur Andersen & Co., footnote 21, above, pages 149-156; Charles J. Anthony, "Tax Considerations in Dealing in Oil and Gas," *Taxes, The Tax Magazine,* December 1950, Vol. 28, page 1205; Lawrence E. Cohn, "Recent Developments in Taxation of Income from Oil and Gas Properties," *New York University Eighth Annual Institute on Federal Taxation,* page 412. New York: Matthew Bender and Company, 1950. See also George E. Ray (Presiding), "Income Tax on Carried and Net Profits Interests in Oil and Gas—Panel Discussion," *Institute on Federal Taxation, 1950, Southwestern Legal Foundation.*

[52] *Helvering* v. *O'Donnell,* 303 U.S. 370 (1938), 20 AFTR 785; *Helvering* v. *Elbe Oil Co.,* 303 U.S. 372 (1938), 20 AFTR 787; *Helvering* v. *Bankline Oil Co.,* 303 U.S. 362 (1938), 20 AFTR 782.

From the standpoint of the assignor, the payments received by him constituted capital gain.

In 1946 the Supreme Court reviewed the taxation of net profits interests again, and without overruling its earlier decisions, held that an assignor who received a net profits interest had not made a sale, but a sub-lease, and had retained an economic interest in oil in place entitling him to deduction for depletion.[53] The effort of the Court to distinguish the earlier cases to the contrary was called an illustration of the "gossamer lines" that the Court has drawn in tax cases by Mr. Justice Frankfurter in his dissenting opinion in the *Burton-Sutton case*.[54] Whether there is any longer a distinction between a depletable and a non-depletable net profits interest, in view of the Supreme Court's effort to draw a distinction between them, which distinction, Mr. Justice Frankfurter said in his dissenting opinion referred to, "hardly can be held in the mind longer than it takes to state," would appear now to be more an academic than a practical question. The Bureau, in practice, has considered that a depletable economic interest may be measured by either gross or net income. The net effect of the Supreme Court's decision is to treat a retained net profits interest as a form of royalty interest representing an economic interest in oil and gas in place. The transaction is treated as a sub-lease rather than a sale, and accordingly the net profits interest is subject to depletion in the hands of the recipient and the assignee of the lease is entitled to deduct from his gross income the amount of the net profits paid by him to the assignor.

In view of the greater certainty as to tax treatment of the net profits interest than exists with respect to the tax treatment of carried interests, many people in the oil business have turned to the net profits interest rather than the carried interest in setting up arrangements which lend themselves to either type of transaction.[55]

The exact nature of the difference between a carried interest on the one hand and a net profits on the other is open to conjecture.[56]

6. Conclusions

It is certainly evident from the above that the types of arrangements involved in assignments of oil interests are both varied and intricate. They are the result of continuing industry and ingenuity on the part of independent oil men in their effort to bring about a sharing of the risk, which is perhaps the predominant characteristic of the independent oil producer and the reason for his survival.

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[53] *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, 34 AFTR 526; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25 (1946), 34 AFTR 1017.

[54] Footnote 53, above.

[55] That there still may be uncertainties with respect to the tax treatment of net profits interests, see Winstead, footnote 51 above, page 526.

[56] Sidney D. Krystal, footnote 51 above, page 173, George E. Ray, footnote 51 above, page 188.

Certainly the oil business is not an easy one in which to succeed. Like any other business, it yields to hard work, plenty of courage and involves certainly more than a share of luck. As in many other fields of endeavor, the grass is always greener on the other side of the street and for every oil man who succeeds there are many who fail, unsung and forgotten.

While there is need for greater certainty with respect to the tax rules relating to the assignment of oil interests, it is clear that progress is being made. During the past few years the rules with respect to the handling of oil payments and net profits interests have been considerably clarified. With respect to carried interests, further clarification, particularly upon the part of the Treasury Department, could be desired. While progress towards such certainty is slow, nevertheless it has been progress, and the answers to the tax questions involved are certainly not simple at the outset. Of one thing the investor in oil may be sure, however, and that is the better his grasp of the rules applicable to the assignment of interests in oil and gas, the greater will be the reduction in the number of risks which will affect the safety and the return on the investor's money. In the oil business, as in every other business involving risk, it is well for the investor to look carefully, not only at the business aspects of the proposed transaction, but at the tax aspects as well, before he leaps.

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Part IX

INDIVIDUAL TRANSACTIONS

79

How to Make Financial Arrangements Before a Marriage

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1. Points to Consider

Federal income, estate, and gift taxes are generally involved in the making or performing of premarital financial arrangements, both at the time they are made and subsequent to the marriage. Additional consideration is required where the particular state imposes similar levies. (The relationship to tax liabilities in case of separation or divorce is treated elsewhere in this book.)

The incidents will be discussed as follows:

Section
- Income Tax 3
  - Basis of property received, for the purpose of determining gain or loss on subsequent disposition .... a
  - Income from property transferred as compared with an attempted assignment of the income alone .... d
  - Deductibility of payments under settlement agreements .... e
  - Special considerations in community property states .... f
- Gift Tax 3
  - Whether a transfer of property for release of marital rights is taxable .... b
  - The valuation of such property for gift tax c
  - The relationship to income tax problems 3
- Estate Tax 4
  - The place of such agreements in estate planning .... a
  - Disallowance of deduction .... b
- Suggested Procedures 5
  - Form of agreement .... a
  - Property v. conjugal rights .... b
  - After-acquired property c
  - Completeness .... d
  - Adequacy of provisions .... e
  - Fair dealing .... f
  - Check list of tax factors .... g

2. Nature and Purpose of Premarital Agreements

Premarital (also referred to as "antenuptial") agreements usually are made between the parties to an intended marriage, but they may also involve third parties having an interest in the occurrence of the contemplated event.

a. Arrangements between the parties themselves may consist of:
  1. An executory agreement in contemplation of marriage
  2. Articles of marriage
  3. Prenuptial settlements.

b. Third parties enter these transactions where they:
  1. Transfer property to one or both parties to the intended marriage
  2. Agree to make such transfers after the marriage occurs.

c. The purposes of these agreements may be considered in a similar division. As between the intended spouses, they desire to:
  1. Define their property rights and regulate the enjoyment and devolution of their real and personal estates[1]
  2. Allow freedom to make appropriate provisions for others
  3. Minimize uncertainty as to financial future and marital tranquility
  4. Accept the provisions that they have arranged in full discharge of the rights that each would otherwise be entitled to.

d. The principal purpose of the third party, generally, is to assure that the marriage will be performed, by:
  1. Offering inducements to the parties to facilitate their marriage
  2. Inducing the parties to refrain from non-performance of their agreement to marry each other.[2]

e. In either type of case, the agreements might involve one or more of the following:
  1. Transfers of real or personal property, directly or in trust
  2. The effecting of insurance, or making changes in existing policies, or providing for payment of insurance premiums directly or through a trust
  3. The making of a will, or changing an existing one
  4. A waiver of any right that one might acquire in the property of the other, including, in some instances, a waiver by one of the right of election against a will made by the other.

3. Income Tax and Gift Tax Effects

The principal effects of premarital agreements upon income and gift taxes appear in determining the tax basis of property and in fixing liability upon the shifting of income.

a. Basis of property received. For income tax purposes, the transaction is treated as equivalent to a purchase and sale, and the wife's basis of the property she receives is, therefore, its fair market value at the time of receipt.[3] The release of marital rights constitutes consideration, and an additional factor is the recognition of absence of donative intent. The court pointed out that "the income tax provisions are not to be construed as though they were in *pari materia* with either the estate tax law or the gift tax statutes," and further, "we think that a transfer which should be classed as a gift under the gift tax law is not necessarily to be treated as a gift income-tax-wise."

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[1] *Leitner* v. *Wass*, 63 N.Y. Supp. 2d 350.

[2] *DeCicco* v. *Schweizer*, 221 N.Y. 431 (1917).

[3] *Doris Farid-Es-Sultanah* v. *Commissioner* (2 Cir. 1947), 160 F. 2d 812, 35 AFTR 1049.

b. Although, for income tax purposes, there is valid consideration in release of marital rights, the rule is to the contrary for gift (and estate) tax purposes. A consideration which is not reducible to money value, such as love and affection or a promise of marriage, is wholly disregarded in determining whether a taxable gift has been made.[4] Also, the question of whether there is or is not a donative intent is immaterial as to the gift and estate tax.

A similar result was reached where the husband compensated the wife for her loss of trust income upon marriage. The payment to the wife was held to be a gift by the husband, because he did not receive any "money" benefit. The common law consideration of detriment to the transferee is not recognized in determining liability for gift tax, except where such detriment occurs "in the ordinary course of business." [5] However, a transfer of property in settlement of the obligation to support, as in a separation or divorce, must be distinguished as it is obviously supported by monetary consideration, as noted in the discussion of those subjects.

c. Consequently, the transfer of property by the husband, in a premarital settlement relating to property, is treated as a gift by him, subject to gift tax on fair market value of the property given by him at the time of the transfer.[6]

d. Shifting of income. It is well known that actual income splitting between husband and wife is now generally unimportant for savings in income taxes in view of the provisions of the Revenue Act of 1948 which allow the benefit in the computation on joint returns. (Treated in a later chapter.)

However, in special situations where the matter is still of importance, it should be noted that an assignment of the "right to income" does not shift the income tax burden from the assignor.[7]

On the other hand, the Treasury Regulations provide that an amount of principal paid under a marriage settlement is a gift, and is not taxable income.[8] Also, a release of dower rights by a wife to the estate of her husband is not income to him.[9]

e. Deductions of payments. Sums paid to a wife under a marriage agreement are deemed in discharge of a personal obligation, and are not deductible from the husband's income.[10] In conformity with this view, damages received for breach of promise to marry are not taxable income,[11] nor are such payments deductible from income.[12]

Members of a partnership are denied a deduction for periodic payments required by an antenuptial agreement between a deceased partner and his widow. It was held that the widow took a share of the profits on a contractual claim and not on an interest in the partnership.[13]

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[4] Reg. 108, § 86.8.

[5] *Commissioner* v. *Wemyss* (1945), 324 U.S. 303, 33 AFTR 584.

[6] *Merrill* v. *Fahs* (1945), 324 U.S. 308, 33 AFTR 587. Cf. *Estate of Ira C. Copley*, 15 T.C. 17.

[7] *Helvering* v. *Horst* (1940), 311 U.S. 112, 24 AFTR 1058; *Commissioner* v. *Sunnen* (1948), 333 U.S. 591, 36 AFTR 611.

[8] Reg. 118, § 39.22(b)(3)-1.

[9] *Fidelity & Columbia Trust Co.* v. *Lucas*, 11 F. Supp. 537 (W.D. Ky. 1935).

[10] O.D. 275, 1 C.B. 159.

[11] *Lyde McDonald*, 9 B.T.A. 1340 (1927).

[12] O.D. 546, 2 C.B. 157.

[13] *Lester G. Hathaway*, 16 B.T.A. 1318 (1929) Cf. *H. W. Kelley* (1942), Par. 42,544 PH Memo. Also, See IRC §§ 736 and 753.

However, an estate may deduct payments from income going to a widow of the decedent, where monthly payments are required to be made pursuant to a prenuptial agreement.[14]

Such payments, although treated as gifts of income, are taxable to the widow, under the rule that gifts that are payable at intervals regardless of income are taxable if in fact paid out of income.[15]

Similarly, the estate is allowed the deduction to the extent that the payments do not exceed the distributable income for the taxable year.[16]

Where a widow was entitled to an annuity under an antenuptial agreement, and the deceased husband had also provided in his will for the annuity payments, and the widow did not elect whether to take under the contract or the will, the payments were taxable to her as being paid from income. Correspondingly, the fiduciary was allowed a deduction.[17]

A husband was taxed on the entire proceeds of a sale of real estate and was allowed no deduction for the amount he was required to pay to his wife as the price she demanded for her dower rights. The dissenting opinion indicated a possible alternative procedure to avoid this result, citing *Frank* v. *Commissioner,* (3 Cir. 1931) 51 F 2d 923.[18]

f. In community property states, an agreement between intended spouses that their earnings after marriage shall be the separate property of the spouse earning the income, free of any community right or claim by the other, will be recognized for income tax purposes. Such an arrangement is generally valid, and the income tax will be imposed in accordance with the ownership of the earnings.[19] The Bureau of Internal Revenue will follow the decision of the Court, based upon the law of the particular community property state.[20] Property, once shown to be separate, is presumed to remain separate until an agreement to transmute it to community is shown. Such an agreement need not be formal, and may be either oral or written, but its existence must be established by clear and unequivocal (or direct and positive) evidence.[21] Local law requirements, however, must be carefully observed. A prenuptial agreement regarding separate property rights under community property law was recognized in Louisiana[22] but an oral agreement was not effective under Philippine Law because not recorded in a public instrument.[23] The tax consequences were recognized where an intended wife assigned 40 per cent of her earnings to her mother, and the prospective husband in a concurrent antenuptial agreement waived his right to consider that part of the prospective wife's earnings as part of their community property.[24]

g. The tax result of a pre-marital agreement or of a marriage effected in a foreign country is discussed in *Sidney Blumenthal*, 15 B.T.A. 1394 and a Bureau letter dated March 4, 1943, par. 17058C, P-H Fed. Tax Service, 1955.

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[14] *Alice M. Townsend,* 12 T.C. 692 (1949), Aff'd. (6 Cir. 1950), 181 F. 2d 502.

[15] 1954 IRC § 102; 1939 IRC § 22(b)(3).

[16] 1954 IRC § 661; 1939 IRC § 162(d)(1); Mim. 4146, XIII-1 C.B. 93.

[17] *Charles W. Somers Trust* (1952), Par. 52,020 P-H Memo T.C.

[18] *Frank J. Digan,* 35 B.T.A. 256 (1937).

[19] *Helvering* v. *Hickman* (9 Cir. 1934), 70 F. 2d 985, 14 AFTR 229.

[20] G.C.M. 18884, 1937-2 C.B. 58.

[21] *Margaret A. Reeve* (1947), Par. 47074 P-H Memo T.C.

[22] *Clay* v. *U.S.* (5 Cir. 1947), 161 F. 2d 607.

[23] *Mary A. Marsman,* 18 T.C. 1, modified (4 Cir. 1953) 205 F. 2d 335.

[24] *David Rose* (1945), par. 45,006 P-H Memo. T.C.

4. Estate Tax Effects

a. The disposition of a material part of the husband's property, or the agreement to make a specified distribution of a material part of his estate, should be given careful consideration in connection with the following factors in estate planning: (1) effect upon the marital deduction allowable for estate tax, (2) taxability of the transfer as a gift in contemplation of death, and (3) effect upon taxability of any other gifts made at same time, or with reference to the settlement.

Court decisions have pointed out that the estate tax and gift tax are construed together, but are distinguishable from the income tax.

b. No deduction from the estate is allowed for claims of a surviving spouse based on relinquishment of marital rights in the decedent's estate, as this does not constitute consideration in money or money's worth.[25]

5. Suggested Procedures in Drafting Premarital Agreements

a. Follow all statutory requirements as to form. The law favors marriage settlements and will seek to uphold them.[26] A contract made between persons in contemplation of marriage remains in full force after the marriage takes place. Some states expressly authorize the making of marriage contracts. New York does so, holding that the general requisites for validity are the same as for ordinary contracts, and, in addition, that the statute of frauds applies. The general requisites are that there be:

1. Parties of mature years.
2. Ability to understand fully the nature and meaning of the agreement.
3. Sufficient consideration, which may be: (a) Any valuable consideration, (b) Reciprocal stipulation, (c) The marriage itself (usually in cases involving a third party).
4. A making of the contract in compliance with the statute of frauds. New York requires that agreements made in consideration of marriage, except mutual promises to marry, must be in writing and signed by the party to be charged, or by his agent, in order that they be enforceable.[27]

The occurrence of the marriage itself does not constitute such part performance as would take the agreement out of the statute of frauds.[28] However, if the provisions have been carried out, an oral contract will not be disturbed.

As to third parties, the usual consideration is the marriage itself. Where that is so, it need not be recited, but the contract is enforceable if a valid marriage is solemnized. An invalid marriage constitutes a failure of consideration.

b. Confine the agreement to property rights. The rights released in a premarital agreement may be classified as to conjugal or property rights.

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[25] 1954 IRC, § 2043(b); 1939 IRC § 812(b).

[26] *Johnston* v. *Spicer*, 107 N.Y. 185 (1887).

[27] *Personal Property Law of New York*, § 31, Subdiv. 3.

[28] *Hunt* v. *Hunt*, 171 N.Y. 396 (1902).

1. Conjugal rights. The parties may not contract to vary their conjugal duties and rights. The laws of New York provide that a husband and wife may not contract to: (A) Alter or dissolve the marriage, or (B) Relieve the husband from his liability to support his wife.[29]

Consequently, a contract that looks forward to the future separation of husband and wife, as by provisions for alimony in case of separation or divorce, is violative of public policy. Similarly, a wife's promise not to demand support is void. To the same effect are provisions that cast upon the intended wife the duty to support the expected family, or that would require her to pay for her own care and maintenance.

2. Property rights. These may be varied by the parties, and usually relate to: (A) dower, (B) share of husband's estate, (C) right to elect against provisions in husband's will, (D) statutory allowance to the widow.

c. Relate the agreement to present owned and after-acquired property. (A) Dower. A wife may not release to her husband her inchoate dower right,[30] but such a release may be made prior to the marriage. In case of any such release, any pecuniary provision made for the benefit of an intended wife and in lieu of dower, if assented to by her as prescribed in Section 197, bars her right or claim of dower in all the lands of her husband.[31] If there is reasonable doubt as to whether the antenuptial agreement was made in lieu of dower, the widow will take both the dower and the proceeds of the antenuptial agreement.[32] Share of husband's estate. Release of this right by the wife requires as consideration something in addition to the marriage itself. (C) Right to elect against provisions in husband's will. A waiver of this right is effective under New York law if subscribed by the maker and either acknowledged or proved, as is required for recording a real property conveyance. The waiver may be: (1) executed before or after marriage, (2) unilateral or bilateral in form, (3) with or without consideration, (4) absolute or conditional.[33]

d. Make the agreement specific and complete. An antenuptial agreement will be strictly construed and not extended to include property not referred to in the agreement.[34]

e. Allow the wife a fair share of the property, in proportion to the financial means of the husband. In general, the test of adequacy of consideration for the wife's waiver of these property rights is whether the provision for her is sufficient to enable her to live comfortably in event of the death of the husband, and in substantially the same style as previously.

The usual criterion of the adequacy of the settlement, therefore, is the character and value of the husband's property.

f. Prepare to prove fair and full disclosure in making the agreement, and the absence of fraud or duress.

1. Outline the nature, extent, and value of the husband's property and attach a financial statement to the contract.

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[29] Domestic Relations Law of New York, § 51.

[30] *Stokes* v. *Stokes*, 119 Misc. 168, 196 N.Y. Supp. 184 (1922).

[31] Real Property Law of New York, §§ 197, 198.

[32] *In re Carnevale's Will* (1936), 158 Misc. 290, 285 N.Y. Supp. 591.

[33] Decedents' Estate Law of New York, § 18, Subdiv. 9.

[34] *In re Van Hoecke's Will*, 197 Misc. 339, 93 N.Y. Supp. 2d (1949).

2. Provide for independent legal advice for the wife.

3. Have witnesses to the transaction to prove the facts and circumstances.

The husband owes a fiduciary duty to his wife because of the intimate relationship. Under some conditions, a marriage settlement may be invalid as against creditors, where the husband is insolvent, but not as against a wife who is not party to the fraud,[35] even if annulment or divorce ensued.[36]

g. Consider the tax effects of the form and content of the agreement.

1. Where property is transferred, the fair market value at the time of transfer will determine the future income tax basis to the recipient, and the gift tax liability of the transferor.

2. The receipt of principal is a gift and therefore is not taxable income, nor is it a deduction to the transferor.

3. An anticipatory assignment of income will not shift the income tax liability to the assignee, but a transfer of income producing property will result in tax liability to the transferee thereafter.

4. Income tax liability may be shifted in a community property state by appropriate agreement, even with respect to future earnings.

5. The Revenue Act of 1948 has added new considerations with respect to income tax splitting by spouses, and the marital deduction in gift and estate taxation.

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[35] *Kerker* v. *Levy,* 125 N.Y. Supp. 357.

[36] *American Surety Co. of N.Y.* v. *Conner,* 251 N.Y. 1 (1929).

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How to Make Arrangements Before and After a Separation or Divorce

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Arrangements between spouses before or after divorce or separation, (a) for the division of property or (b) for the support and maintenance of the wife (and children, if any), or both, have substantial tax consequences which, if ignored, may often lead to considerably more remorse than their parting would otherwise have occasioned. It is the purpose of this chapter to consider the various potential income tax liabilities inherent in transactions of this nature and to point up possible methods of controlling the results.

1. Points to Consider

To provide a convenient frame for reference purposes, the following illustrative case will be assumed.

H and W are husband and wife, residing in the State of New York, with their two minor children. In the course of their marriage they have accumulated property in the form of a home and furnishings, a car, a $50,000 life insurance policy on the husband's life, and cash and securities, having the following costs and values:

	Cost	*Value*
Residence	$25,000	$40,000
Furnishings	10,000	5,000
Car	3,000	2,000
Cash	10,000	10,000
Securities	30,000	50,000
$50,000 Life Insurance Policy	15,000*	10,000 (cash surrender value)
	$93,000	$117,000

H and W have decided to separate. They contemplate that W sometime thereafter will proceed to Reno, Nevada and obtain a divorce. They have tentatively decided on the following disposition of the property between them:

Home and Furnishings	W to have the use of the residence and furnishings so long as she desires to maintain it as a home for herself and the children.

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* Premiums paid to date.

Car	To be assigned to W.
Cash	$5,000 to W to reimburse her for a previous advance.
Securities	Certain securities purchased by H for $10,000 but now worth $25,000 to be assigned to W.
Life Insurance Policy	Policy to be maintained by H, proceeds payable to W or, in the event W predeceases H, to H's estate.

The parties have also tentatively agreed that H shall pay one-third of his income or $1,000 a month, whichever is the lesser, for the support and maintenance of W and the children. This amount is to be reduced to $500 for the support of the children in the event the wife remarries before the children reach 21. H also has agreed to pay $50 per month for the support of W's aged mother during the balance of her lifetime.

H approaches you to advise him of any income tax complications that this arrangement might involve. He informs you that in partial settlement of the support obligation he is contemplating the purchase of an annuity contract to cover support and maintenance payments of $300 per month for W and the children from certain funds he inherited from his father. The cost of such annuity contract, he states, will be $90,000. As an alternative, or to supplement such contract, he is considering the transfer of certain securities he has inherited (basis $25,000, value $50,000) to a revocable trust, the income to be paid to W for life.

Under the circumstances, the basic problem facing you is the taxability for income tax purposes of the alimony payments made both before and after the divorce, and the effects thereon of W's remarriage or of H's predeceasing W.

A check list of some of the principal specific problems which require consideration is as follows:

Taxability of Alimony Payments	*Section*
Will the payments, if made directly by H, be taxable as income to W and deductible by H?	2
Any difference in the result with respect to the payments made before and after the entrance of the divorce decree and during the separation?	2 a,b
Are the payments for the benefit of the children and W's mother taxable as income to W and deductible by H?	2 f
If a trust is set up by H, is the income of the trust taxable to W and deductible by H?	2, 4
Any difference in result if the payments are made from the principal of the trust?	3
If the annuity policy is purchased, is the income taxable to W and deductible by H?	2, 3
Will the taxability of the foregoing payments be altered by H's death before W's?	2 d
Will the use of the residence by W make the rental value taxable as income to her and deductible by H?	2 c
Will payment of the premiums on the life insurance policy be taxable as income to W and deductible by H?	2 c
Will payment of the insurance proceeds be taxable as income to W?	3
Will the payment of $5,000 be taxable as income to W and deductible by H?	2 d

This chapter approaches the above problems, first by outlining briefly the applicable 1939 and 1954 Code provisions, and second by separately considering the more important statutory limitations and the gloss thereon which results from administrative regulations and court decisions.

2. Income Taxation of Direct Alimony Payments

Before 1942, alimony or separate maintenance payments paid directly by the husband to the wife were not taxable as income to the wife nor deductible by the husband.[1] It had been held that the husband was taxable on income from alimony trusts if he had a "continuing obligation" to support his former wife under local law or the trust instrument.[2]

The 1939 Code. The Revenue Act of 1942 completely reversed this situation by adding three new sections to the 1939 Code: Sections 22(k), 23(u) and 171. Under these sections, generally speaking, amounts paid periodically as alimony or for the separate maintenance of the wife pursuant to a decree of divorce or of separate maintenance were taxable as income to the wife under Section 22(k), and were deductible by the husband under Section 23(u). If such amounts were attributable to property transferred in trust or otherwise, under such circumstances as to be includible in the gross income of the wife under Sections 22(k) or 171(a), they were not includible in the gross income of the husband. Under Section 23(u), any payments includible in the wife's income, under Section 22(k), were deductible by the husband, excepting, of course, such payments originally excluded from the gross income of the husband under Section 22(k) or 171(a).[3]

The 1954 Code. The 1954 Code has made important changes in the income taxation of alimony payments, although the exact limits of such changes remain uncertain. The 1954 Code sections which correspond to Sections 22(k), 23(u) and 171 of the 1939 Code are Sections 71, 215, and 682, respectively.

The changes of primary importance are made by Section 71(a) which, after restating in subsection (1) the basic provisions of Section 22(k), making certain alimony payments taxable to the wife in the case of divorce or legal separation, then extends the same tax treatment to two additional situations not covered by the 1939 Code. Under Section 71(a)(2), the wife is for the first time subject to tax on payments from her husband, or attributable to property transferred in trust or otherwise, even though there has been no decree of divorce or of separate maintenance. For the section to apply, it is necessary that at the time the payments are received the parties are "separated"; the parties do not file a joint return; the payments are periodic and are made because of the marital or family relationship; and the payments are made under but are received subsequent to a "written separation agreement" between the parties executed after August 16, 1954 (the date of enactment of the 1954 Code).[4]

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[1] *Gould* v. *Gould*, 245 U.S. 151, 3 AFTR 2958 (1917). See *Daisy M. Twinam*, 22 T.C. 83 (1954), upholding the constitutionality of 1939 IRC § 22(k) and suggesting in the light of more recent Supreme Court decisions that the *Gould* case may have been incorrectly decided.

[2] *Douglas* v. *Willcuts*, 296 U.S. 1, 16 AFTR 970 (1935); *Helvering* v. *Fuller*, 310 U.S. 69, 24 AFTR 667 (1940).

[3] See, generally, Alan L. Gornick, "Alimony and the Income Tax, Background and Effect of the Provisions in the Revenue Act of 1942," *Cornell Law Quarterly*, 1943, Vol. 29, page 28; Harry J. Rudick, "Marriage, Divorce and Taxes," *Tax Law Review*, 1946, Vol. 2, page 123.

The other new provision, found in Section 71(a)(3), includes in the wife's taxable income periodic payments received by her after August 16, 1954 from her husband, under a support or maintenance decree entered after March 1, 1954.[5] This provision, like Section 71(a)(2), is applicable only if the parties are "separated," and if they do not file a joint return. One noteworthy point of distinction between Section 71(a)(3) and Sections 71(a)(1) and (2), is that Section 71(a)(3) applies only to payments from the husband and not also, like the other provisions, to payments which are attributable to property transferred in trust or otherwise.[6]

Under Section 215 of the 1954 Code, the husband's deduction has been extended to cover the payments now taxable to the wife under Section 71(a)(2) and (3), as well as the payments taxable under Section 71(a)(1). Following the same pattern as the 1939 Code provisions, however, amounts which under Section 71(a) are includible in the wife's income and are attributable to transferred property rather than to direct payments from the husband, are expressly excluded from the husband's income by Section 71(d) and are not, of course, also deductible under Section 215.

Many questions raised by the new statutory provisions await clarification. Application of Sections 71(a)(2) and (3), for example, will depend upon whether the wife is "separated" from her husband. The Congressional committee reports suggest only the requirement that "they are living apart." [7] Inasmuch as a husband and wife who are not divorced or legally separated may file a joint return[8] and thereby in effect receive the same income splitting benefits as are possible under Section 71 there may be no practical difficulty with this concept. In any event, such questions as may arise when couples are "living apart" for reasons other than marital discord will doubtless turn on whether a "written separation agreement has been executed.

Written separation agreement. The concept of a "written separation agreement" under Section 71(a)(2) is also new to the tax law, having no counterpart in the 1939 Code. What type of agreement will be required? The authorities construing the "written instrument incident to such divorce or separation" provisions of Section 22(k) of the 1939 Code (now found in Section 71(a)(1) of the 1954 Code) may prove helpful.[9] Probably informal correspondence between the parties should be sufficient to construct the "written" agreement.[10] Must the "agreement" under Section 71(a)(2), like the "instrument" under Section 71(a)(1), impose a legally enforceable obligation on the husband? According to the Congressional committee reports, payments may be taxable to the wife under Section 71(a)(2) "whether or not the agreement is an instrument enforceable in a court of law." [11] Nevertheless, it is not clear that every written agreement calling for periodic payments by husband to wife, where the parties are "separated," would necessarily qualify as a "separation agreement." This language implies that, in addition to specifying such payments, the writing should also set out the other terms of the parties' undertaking to become and remain "separated."

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[4] Under the House bill the provisions of Section 71(a)(2) would also have applied to separation agreements executed prior to enactment of the 1954 Code. The August 16, 1954 date was inserted by the Senate Finance Committee, in order that tax planning pursuant to such prior agreements would not be upset. S. Rep. No. 1622 (83d Cong., 2d Sess.) pages 10, 11, 171; cf. Section 110(c) of the Reed-Camp bill, sponsored by the American Bar Association, Hearings before the House Committee on Ways and Means (83d Cong., 1st Sess.) page 226; testimony of Thomas N. Tarleau, Chairman of the American Bar Association's Taxation Section, Hearings before the Senate Committee on Finance (83d Cong., 2d Sess.) page 330.

[5] The House bill did not include the provisions of Section 71(a)(3).

[6] No explanation for this difference appears in the committee reports. Possibly the different tax treatment, under Sections 71(a)(1) and (3), with respect to payments attributable to property transferred in trust or otherwise, was thought to be justified by the fact that it is normal procedure for a divorce or a separate maintenance decree, but not for a support decree, to require such transfers of property.

[7] H. Rep. No. 1337 (83d Cong., 2d Sess.) page 9; S. Rep. No. 1622 (83d Cong., 2d Sess.) page 10.

[8] 1954 IRC § 6013(d)(2); 1939 IRC § 51(b)(5)(B).

Decree for support or maintenance. While Section 71(a)(3), like Section 71(a)(2), requires that the husband and wife be "separated," it does not require a separation agreement. Instead, the payments must be received "under a decree . . . requiring the husband to make the payments for her support or maintenance." This provision, which was added by the Senate Finance Committee, should be compared with Section 71(a)(1), covering payments required "under a decree of divorce or of separate maintenance." [12] As explained in the Committee report, Section 71(a)(3) was added "to cover cases where amounts made under a court decree for support have not been called separate maintenance payments." [13] Thus, at least where the parties have not been divorced or legally separated under a decree of separate maintenance, periodic payments made by the husband to the wife pursuant to a court decree requiring such payments for her support or maintenance should be taxable to the wife under Section 71(a)(3) and deductible by the husband under Section 215, provided of course that the parties were "separated" at the time the payments were made and that a joint return was not filed.

Possible application of Sections 71(a)(2) and (3) where parties are divorced or legally separated under decree of separate maintenance. An important question is whether the new Section 71(a)(2) and (3) provisions may have any application where the husband and wife are divorced or legally separated under decree of separate maintenance. In other words, will the new provisions be held to extend, in their application, into the area traditionally governed by Section 22(k) of the 1939 Code and now covered by Section 71(a)(1)? Or will the Code provisions be deemed mutually exclusive, with the result that payments received by the wife after the entrance of a decree of divorce or of separate maintenance must qualify, if at all, only under Section 71(a)(1) and not under Sections 71(a)(2) or (3)?[14]

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[9] See discussion at Section 2(e) of this chapter.

[10] Footnote 86, below.

[11] H. Rep. No. 1337 (83d Cong., 2d Sess.) page A21; S. Rep. No. 1622 (83d Cong., 2d Sess.) page 171.

[12] Authorities construing the same provision in 1939 IRC § 22(k) are discussed at Section 2(a) of this chapter.

[13] S. Rep. No. 1622 (83d Cong., 2d Sess.) page 11.

[14] Section 71(a)(1) expressly applies "if a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance." Sections 71(a)(2) and (3) expressly apply "if a wife is separated from her husband." If a dictionary definition of "separated" would generally include separated by divorce or separate maintenance decree, see footnotes 23 and 24, below, it may be contended that if Congress had desired to limit applica-

Section 71(a)(2). To illustrate the importance of the question from the standpoint of intelligent tax planning, we may assume the following situation. A husband and wife agree to separate in January 1955 and thereupon enter into a written separation agreement calling for periodic payments. Neither party contemplates a divorce action, and the separation agreement does not refer to the possibility that such an action will be brought. In March 1956 the wife obtains a divorce, but being satisfied with the provisions of the separation agreement she does not seek an alimony award and none is mentioned in the divorce decree. Under these facts, the periodic payments received by the wife *prior* to entrance of the divorce decree should be taxable to her under Section 71(a)(2) and therefore deductible by the husband under Section 215. The same result might follow as to the payments received *after* entrance of the divorce decree, if Section 71(a)(2) is construed to apply in the case of divorced parties.[15] If, on the other hand, payments between such parties are governed solely by Section 71(a)(1), then the payments *after* divorce, under the facts stated above, would be taxable to the wife and deductible by the husband only if the separation agreement qualified as a "written instrument incident to such divorce or separation." Under the court decisions construing the same language in Section 22(k) of the 1939 Code, there would be a serious risk that the agreement could not so qualify.[16] Moreover, even if the agreement were held to be "incident to" the divorce, the payments would not qualify under Section 71(a)(1) unless the agreement imposed a legal obligation on the husband to make such payments.[17] As noted earlier, on the other hand, a separation agreement may be effective under Section 71(a)(2) although it is not legally enforceable.

The parties in the above illustration may avoid any question involving the continuing application of Section 71(a)(2) after the divorce, or involving the qualification of the separation agreement for purposes of Section 71(a)(1), by either (1) causing the provisions of the agreement to be adopted by or incorporated in the divorce decree or (2) executing a written instrument which will clearly meet the requirements of Section 71(a)(1). Under either procedure, the result in the above illustration should be that the payments received by the wife *after* the divorce and pursuant to the decree or instrument would be subject to the same income tax treatment as the payments received *prior* thereto under the separation agreement.

The same basic question as to the application of Section 71(a)(2) where the parties have been divorced or legally separated under a decree of separate main-

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tion of Sections 71(a)(2) and (3) it would have expressly provided that they apply "if a wife is separated from her husband *other than under a decree of divorce or of separate maintenance*." But see Note, 68 *Harv. L. Rev.* 372, 374 (1954), concluding that Sections 71(a)(2) and (3) "should probably be construed as not applying at all where . . . there has been a divorce."

[15] The House Ways and Means Committee Report states that Section 71(a)(2) applies to "payments received from her husband subsequent to a written separation agreement (whenever entered into). . . ." H. Rep. No. 1337 (83d Cong., 2d Sess.) page A21. However, this language may be directed to the proposition that, unlike the written instrument in Section 71(a)(1), the written agreement under Section 71(a)(2) need not bear any relationship to a court decree so as to be incident thereto. Or the language may merely be explanatory of the fact that, under the House bill, Section 71(a)(2) would have applied to agreements executed *prior* to the date of enactment of the 1954 Code. See footnote 4, above.

[16] See discussion at Section 2(e) of this chapter.

[17] See discussion at Sections 2(d) and (e) of this chapter.

tenance, may also arise in situations where the agreement is executed *subsequent* to the decree. For example, we may assume that a divorce decree is entered in January 1955; that neither a separation agreement nor other written instrument had been executed prior to divorce; and that the decree does not contain any provision for alimony. Subsequently, in 1957, the husband desires to make deductible payments to the wife for her support and maintenance. May that result be achieved through execution by the husband of a written instrument calling for such payments? The problems of proving that such instrument was "incident to" the divorce and imposed a legal obligation on the husband would create serious doubts concerning the deduction under Section 71(a)(1).[18] May the deduction nevertheless be claimed under Section 71(a)(2), if the parties enter into a written agreement?

The husband's deduction under Section 71(a)(2) would probably run a greater risk of disallowance on these facts than in the example previously considered. This is so because in the previous example the agreement, executed *prior* to the divorce, was clearly a "separation agreement." Disallowance of the deduction might therefore require a broad determination that the statutory provisions do not overlap in their application and that consequently Section 71(a)(2) cannot apply to payments which are received after entrance of the divorce decree. In the second illustration, on the other hand, the Internal Revenue Service might successfully contend that, even assuming the section applies to all payments received under *pre*-divorce separation agreements (including payments received after divorce), an agreement *executed after* divorce cannot possibly qualify as a "separation agreement" so as to invoke Section 71(a)(2). Such a contention, equally applicable to an agreement executed after entrance of a separate maintenance decree, would insist that where the parties have thus been divorced or legally separated under court decree, no further terms of the separation remain to be agreed upon, and hence the parties could not execute a "separation agreement" within the meaning of Section 71(a)(2).[19] Until the limits of Section 71(a)(2) become more clearly defined,[20] the husband may consider the possibility of avoiding the risk by making payments to the wife only after entrance of a court decree requiring such payments.

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[18] In a recent decision of the Court of Appeals for the Second Circuit, Judge Harlan (now Mr. Justice Harlan of the Supreme Court) stated by way of dictum: "This does not mean that a written instrument fixing support payments entered into for the first time after a decree of divorce or separation would necessarily fall within the statute, for Section 22(k) also requires that deductible payments must be in discharge of a legal obligation incurred 'because of the marital or family relationship.' Legislative history indicates that the legal obligation to which the statute refers must be in recognition of the general obligation to support, which, it may be argued, in the contemplation of the statute ceases upon dissolution of the marriage status." *Newton* v. *Pedrick* (2 Cir. 1954), 212 F. 2d 357, reversing (D.C., S.D. N.Y. 1953), 115 F. Supp. 368.

[19] But see *Rowena S. Barnum*, 19 T.C. 401 (1952), where the Tax Court referred to an agreement executed some nineteen years after divorce, as a "separation agreement." Query whether, in addition to a possible objection based upon the definition of "separation agreement," it might be contended that payments under a *post*-divorce agreement would not be made "because of the marital or family relationship" as required under Section 71(a)(2). See Newton v. Pedrick, footnote 18 above, where the Court of Appeals suggested that even though a *post*-divorce instrument could qualify as incident to divorce under 1939 IRC § 22(k) (now 1954 IRC § 71(a)(1)), payments thereunder would not be subject to Section 22(k) treatment unless there continued to exist (after divorce) a legal obligation for support. Such obligation could be based upon either a *pre*-divorce agreement or instrument, or a support provision in the decree itself. The effect of *Newton* v. *Pedrick* apparently is that, given the continuing support obligation, an instrument executed after divorce may either increase or

Section 71(a)(3). If the decree thus entered (subsequent to divorce or legal separation) takes the form of an amendment of such prior decree, the payments made after the amendatory decree and required thereby should qualify under Section 71(a)(1) as being pursuant to an obligation imposed by a "decree of divorce or of separate maintenance." [21] Assuming, however, that payments under the subsequent decree fail to qualify for purposes of Section 71(a)(1), may they nevertheless be taxable to the wife under Section 71(a)(3)?

The problem is somewhat different from that involving possible post-divorce application of Section 71(a)(2), discussed above, because there are significant differences in the provisions of the two subsections. While each applies only where the parties are "separated," Section 71(a)(3) does not further require a separation agreement, or that the payments be made "because of the marital or

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reduce the total support payments, and such payments will be covered by 1939 IRC § 22(k) (1954 IRC § 71(a)(1)). Does the same reasoning necessarily apply to Section 71(a)(2), with the result that, in the example given, the payments under the *post*-divorce agreement would fall outside the section? The language of Sections 71(a)(1) and (2) suggests a possible basis for distinction. Thus, like 1939 IRC § 22(k), Section 71(a)(1) requires that the payments be received "in discharge of . . . a legal obligation which, because of the marital or family relationship, is imposed on . . . the husband." Section 71(a)(2), on the other hand, requires only that the payments be made "because of the marital or family relationship."

[20] A statement filed with the Senate Finance Committee by the American Bar Association's Taxation Section indicates that Section 71(a)(2) was not understood by that group to apply generally to agreements executed by divorced spouses, since the statement recommended that "consideration should be given . . . to extending the same treatment to payments made under written agreements between divorced former spouses even though not embodied in a decree of the court granting the divorce." Hearings before the Senate Committee on Finance (83d Cong., 2d Sess.) page 483. The same understanding is implied in a letter to the Senate Finance Committee from a firm of certified public accountants, published at page 1603 of the Hearings. The Senate Finance Committee Report explains that Section 71(a)(3) "is applicable only if the wife is separated from her husband, but such separation *need not* be under a decree" (italics added), leaving the possible inference that such separation *may* be under a decree of divorce or of separate maintenance. S. Rep. No. 1622 (83d Cong., 2d Sess.) page 171. Section 682 (corresponding to 1939 IRC § 171) provides that where the husband's alimony obligation is funded in a trust, the wife is taxable on the trust income. The section expressly applies to "a wife who is divorced or legally separated under a decree of divorce or of separate maintenance (or who is *separated* from her husband *under a written separation agreement*)." (Italics added). The Committee reports explain that the parenthetical clause "makes the provisions of this section applicable to spouses who are *separated under a written separation agreement*, as well as to those who are divorced or legally separated under a court order or decree. This change correlates the provisions with section 71 of this bill." (Italics added). H. Rep. No. 1337 (83d Cong., 2d Sess.) page A218; S. Rep. No. 1622 (83d Cong., 2d Sess.) page 372. It might be contended, from the italicized language above, that Congress intended Section 71(a)(2) to apply only where, at the time the payments are received by the wife, the parties are separated "under" a written separation agreement. But after a divorce or separate maintenance decree has been entered, may the parties thereafter be correctly described as separated "under" a separation agreement? Or are they then separated solely "under" the decree, although a private agreement excuted either before or after such decree continues in effect? On its face, Section 71(a)(2) is applicable "if a wife is separated from her husband and *there is* a written separation agreement." (Italics added). The Section does not expressly require that the parties be separated "under" such agreement.

[21] An alternative theory—that the subsequent decree is itself a written instrument incident to divorce and the payments are therefore covered by Section 71(a)(1)—would be questionable under the reasoning of *Newton* v. *Pedrick*, footnotes 18 and 19, above, since in the example given there may be no continuing legal obligation for support after divorce.

family relationship."[22] Section 71(a)(3) should, therefore, be held to apply in the case of divorced or legally separated parties, if the term "separated" is defined to include the status of living apart under divorce or separate maintenance decree. Dictionary definitions may be helpful,[23] or may not.[24]

Statutory limitations which have been tested in the courts. The 1954 Code's alimony provisions include six limitations which were adopted from the 1939 Code and therefore have been tested in extensive litigation. These limitations in Sections 22(k) and 23(u) of the 1939 Code, which are continued in full force in Section 71(a)(1) but are in some instances not applicable to Sections 71(a)(2) and (3), may be listed as follows:

1. The parties must be divorced or legally separated under a *decree* of divorce or under a *decree* of separate maintenance.
2. The payments must be received *subsequent* to the decree of divorce or of separate maintenance.
3. The payments must be "periodic payments."
4. The payments must be in discharge of a legal obligation imposed upon, or incurred by, the husband.
5. The obligation must be imposed upon the husband under the decree of, or incurred by him under a written instrument incident to, the divorce or legal separation.
6. The amount or portion of the payments specifically designated in the decree, or in the written instrument incident thereto, as a sum which is payable for the support of minor children of the husband, is not includible in the gross income of the wife nor deductible by the husband.

Each of these limitations will be discussed hereinafter.

a. The parties must be divorced or legally separated under a decree. As discussed earlier, this limitation in Section 22(k) of the 1939 Code has been eliminated in Sections 71(a)(2) and (3), but continues to apply under Section 71(a)(1). It was held under Section 22(k) that payments received by the wife pursuant to a voluntary separation agreement were not taxable to her nor deductible by the husband, because the payments did not meet the strict statutory requirement.[25] This was so, even though, under the applicable state law, such a separation agreement was fully equivalent to a separation by judicial decree.[26] Furthermore, for Section 22(k) and Section 71(a)(1) to apply, there not only must be a decree but the parties must actually be divorced or legally separated pursuant thereto. Thus, it has been held that a court order declaring payment of alimony *pendente lite* is not a "decree" of divorce or of separate maintenance within the meaning of Section 22(k).[27] Nor would a support order of a Court, such as the Atlantic

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[22] Problems involving those requirements in Section 71(a)(2) are noted at footnotes 19 and 20, above.

[23] *Webster's New International Dictionary (2d Ed. Unabridged)*. Springfield, Mass.: G. & C. Merriam Co., 1953.

[24] *Black's Law Dictionary (3d Ed)*. St. Paul, Minn.: West Publishing Company, 1933; *Bouvier's Law Dictionary (Cent. Ed.)*. Cleveland: Banks-Baldwin Law Publishing Co., 1946.

[25] *George D. Wick*, 7 T.C. 723 (1946), affirmed *per curiam* (3 Cir. 1947), 161 F. 2d 732, 35 AFTR 1366; *F. Ellsworth Baker*, 17 T.C. 1610 (1952), modified (2 Cir. 1953), 205 F. 2d 369.

[26] *Smith v. Commissioner* (2 Cir. 1948), 168 F. 2d 446, 32 AFTR 438.

[27] *George D. Wick*, footnote 25, above; *Robert A. McKinney*, 16, T.C. 916 (1951); *Richard C. Richardson*, T.C. Memo. 1955-234.

County Juvenile and Domestic Relations Court of New Jersey, be considered a decree under Section 22(k) and Section 71(a)(1),[28] although it should now qualify as a support decree under Section 71(a)(3). An order issued to an officer in the United States Marine Corps by the Commandant thereof, requiring support payments to the officer's wife, fails of course to qualify as a court decree.[29] So does an order of a divorce court, discontinuing the wife's divorce suit and noting that the discontinuance was "based upon the separation agreement" between the parties.[30]

An interlocutory decree of divorce entered in Colorado is not considered by the Tax Court or the Court of Appeals for the Tenth Circuit as equivalent to a decree of divorce or separate maintenance.[31] The Internal Revenue Service, on the other hand, ruled some years ago that a California interlocutory decree is to be given effect as a final decree of divorce or separate maintenance under Section 22(k).[32] The controversy may have lost most of its significance, since payments in the nature of support or maintenance under an interlocutory decree should now be covered by Section 71(a)(3) if the decree fails to qualify as a divorce or separate maintenance decree under Section 71(a)(1).[33] The Service has a further interest in maintaining its position, however, for if an interlocutory decree is not equivalent to a decree of divorce or separate maintenance, the separated spouses naturally retain the right to file a joint return for years ending prior to the entry of the final decree.[34]

The decree of divorce does not have to be one which will be given effect in the parties' marital domicile. The Service has ruled that alimony payments were deductible under a separation agreement incident to a Mexican divorce decree obtained by the wife, and in reliance on which the husband had remarried, although it was of doubtful validity in Connecticut, the state in which they were living.[35] The Service has also ruled that a judgment annulling a marriage for a cause which made the marriage void *ab initio* does not meet the requirements of a "decree" of divorce or of separate maintenance.[36] On the other hand, a decree of annulment under the German Code has been held to meet such requirements where the wife exercised an election available to her under German law to treat the annulment "as if the marriage had been dissolved by divorce." [37]

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[28] *Angelo Frascone*, par. 49,095 Prentice-Hall Memorandum T.C. (1949); *Frank J. Kalchthaler*, 7 T.C. 625 (1946) (Domestic Relations Court of New York City); *Edward S. Gerrish*, par. 53,187 Prentice-Hall Memorandum T.C. (1953).

[29] *Edgar Jodoin*, par. 53,311 Prentice-Hall Memorandum T.C. (1953).

[30] *Portfolio* v. *U.S.* (Ct. Cls. 1954), 118 F. Supp. 367, cert. den. 348 U.S. 827 (1954).

[31] *Alice Humphreys Evans*, 19 T.C. 1102 (1953), affirmed (10 Cir. 1954), 211 F. 2d 378. The Commissioner's nonacquiescence, 1953-2 C.B. 8, has not been withdrawn. See Rev. Rul. 55-178, 1955 IRB No. 13 (p. 31).

[32] I.T. 3761, 1945 C.B. 76, modified by I.T. 3934, 1949-1 C.B. 54, but modification withdrawn by I.T. 3944, 1949-1 C.B. 56.

[33] Determination as to whether the decree could qualify under Section 71(a)(1) rather than merely under Section 71(a)(3) would be especially important if, pursuant to the decree, payments were made out of property transferred in trust or otherwise, see footnote 6, above; or if the payments were required under a written instrument incident to the decree, and not under the decree itself.

[34] Rev. Rul. 55-178, footnote 31, above; *William G. Ostler*, T.C. Memo. 1955-207; *Marriner S. Eccles*, 19 T.C. 1049 (1953), affirmed *per curiam* (4 Cir. 1953), 208 F. 2d 796; 1954 IRC § 6013(d)(2); 1939 IRC § 51(b)(5)(B).

[35] G.C.M. 25250, 1947-2 C.B. 32; *Feinberg* v. *Commissioner* (3 Cir. 1952), 198 F. 2d 260, 42 AFTR 363.

[36] Letter ruling, dated December 8, 1944, 1945 Prentice-Hall Federal Tax Service par. 76,075.

In the illustrative case stated originally, payments made to the wife after the separation agreement and before the entrance of the contemplated divorce decree in Reno, would not under the 1939 Code have been taxable to the wife nor deductible by the husband, notwithstanding the existence of a written separation agreement between the parties. If, however, such an agreement is executed after August 16, 1954, periodic payments thereafter may now be covered under Section 71(a)(2) with the resulting tax to the wife and deduction by the husband.

b. The payments must be received subsequent to the decree. This limitation in Section 22(k) has been carried over to Section 71(a)(1). Under the express statutory language, the payments to the wife must be received *after*[38] the decree of divorce or separate maintenance.[39] It has been held that, notwithstanding a property settlement and separation agreement, payments made before such a decree could not qualify under Sections 22(k) and 23(u), even though a decree of divorce was later obtained ratifying and approving such terms.[40] The courts have reached a similar result where the decree was ordered to be entered retroactively as of the date of the original agreement between husband and wife.[41]

Section 71(a)(3) does not expressly require that payments under a support decree, in order to qualify for purposes of that section, be made *after* such decree. A possible explanation for the difference in language is that, unlike Section 71(a)(1), there is no provision in Section 71(a)(3) for payments under a written instrument or separation agreement. Thus, Congress may have understood that a payment "under" a support decree would necessarily be made *after* such decree. This explanation would be consistent with a statement in the Senate Finance Committee Report that "the tax effect" of a support decree under Section 71(a)(3) "should be the same as in the case of a decree of separate maintenance." [42]

c. The payments must be "periodic" payments. Sections 71(a)(1), (2) and (3), like Section 22(k) of the 1939 Code, require that the payments be "periodic" payments as opposed to "installment" payments of a principal sum, with the single exception discussed hereinafter. Since the term "periodic" is not defined, the proper application of this requirement has led to a considerable amount of litigation. In the illustrative case, for example, it appears that the fair rental value of the house and furnishings occupied by the wife and children under the proposed settlement agreement and court decree would not constitute a "periodic" payment, because the wife's property right to occupy is not received "periodically" but as a single right at the time of the agreement or decree.[43] A lump sum payment to the wife to cover her legal and medical expenses is not periodic.[44] The Court of Appeals for the Third Circuit has expressly reserved decision as to whether a husband's obligation to furnish the wife a new car each year would give rise to periodic payments as contemplated by the statute.[45]

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[37] *Lily R. Reighley*, 17 T.C. 344 (1951); *Reginald B. Parsons*, par. 51,297 Prentice-Hall Memorandum T.C. (1951).

[38] "Subsequent to such decree," in 1939 IRC § 22(k) was changed to "after such decree" in 1954 IRC § 71(a)(1).

[39] *Smith Estate* v. *Commissioner* (3 Cir. 1953), 208 F. 2d 349, modifying par. 52,343 Prentice-Hall Memorandum T.C. (1952); Benjamin F. Birdwell, T.C. Memo. 1955-220.

[40] *Robert Barry*, par. 48,015 Prentice-Hall Memorandum T.C. (1948).

[41] *Robert L. Daine*, 9 T.C. 47 (1947), affirmed (2 Cir. 1948), 168 F. 2d 449, 36 AFTR 1080.

[42] Footnote 6, above.

[43] *Pappenheimer* v. *Allen* (5 Cir. 1947), 164 F. 2d 428, 36 AFTR 406.

When, pursuant to the agreement or decree, the husband carries insurance on his life for the benefit of his wife, the question whether the premiums he pays represent "periodic payments" of alimony is one of fact. Payments pursuant to a decree providing that a fixed portion of the husband's income is to be paid the wife as alimony, but that insurance premiums paid by the husband are to be subtracted from the cash alimony payments required of him under the decree, have been held to qualify as "periodic payments" constructively received by the wife.[46] Even in the absence of such special provisions, the Tax Court has held that if the wife were designated irrevocable beneficiary, and the children, if any, contingent beneficiaries, the premiums paid by the husband could qualify as "periodic payments." [47] Preliminary to the question whether premium payments by the husband are "periodic," it must be determined whether they are "payments" to the wife at all. The Courts have had considerable difficulty with this question, which involves thorny problems of constructive receipt. Under the early Tax Court cases it was considered unimportant that the wife naturally would have to predecease the husband to receive any of the proceeds, or even that he had expressly reserved the right to name a successor beneficiary if he should survive the wife and their children; but if the agreement or decree clearly stated that the insurance was maintained to secure the wife against default of the husband or his estate as to the required cash alimony payments, the husband's premium payments generally were not treated as payments of alimony to the wife.[48] It is interesting to note that in those cases where the wife was required under the agreement or decree to give up her interest in the policy on termination of the husband's alimony obligation prior to her death, the cases uniformly reached the result, although for a variety of reasons, that premium payments were not intended as additional alimony.[49]

The rule currently applied by the courts stems chiefly from an opinion by the Court of Appeals for the Seventh Circuit in *Seligmann* v. *Commissioner*.[50] The

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[44] *F. Ewing Glasgow*, 21 T.C. 211 (1953), acq. 1954-1 C.B. 4.

[45] *Smith Estate* v. *Commissioner*, footnote 39, above, where the car was not shown to have been furnished subsequent to the divorce decree.

[46] *Boies C. Hart Estate*, 11 T.C. 16 (1948), acq. 1949-1 C.B. 2.

[47] *Leon Mandel*, par. 49,105 Prentice-Hall Memorandum T.C. (1949); *Edna Horn Seligmann*, par. 52,344 Prentice-Hall Memorandum T.C. (1952); *Lemuel Alexander Carmichael*, 14 T.C. 1356 (1950), acq. 1950-2 C.B. 1; I.T. 4001, 1950-1 C.B. 27.

[48] *Meyer Blumenthal*, 13 T.C. 28 (1949), affirmed (3 Cir. 1950), 183 F. 2d 15, 39 AFTR 628; *William J. Gardner*, 14 T.C. 1445 (1950); *Halsey W. Taylor*, 16 T.C. 376 (1951); cf. *Lemuel Alexander Carmichael*, footnote 47, above, where one group of policies was held to be intended as security and another as alimony, although both were listed in the agreement under the heading "security." See also I.T. 4001, footnote 47, above and cases cited.

[49] *F. Ellsworth Baker*, footnote 25, above, modified on another issue (2 Cir. 1953), 205 F. 2d 369 (wife ceased to be irrevocable beneficiary on remarriage or termination of period of seven years and eight months, over which alimony payable); cf. *Lemuel Alexander Carmichael*, footnote 47, above (policies to be returned to husband on receipt by wife of alimony payments equal to face amount of policy); *Halsey W. Taylor*, footnote 48, above (policy to be surrendered to husband on wife's remarriage); similarly, *Meyer Blumenthal*, footnote 48, above, and *William J. Gardner*, footnote 48, above.

[50] (7 Cir. 1953), 207 F. 2d 489, reversing *Edna Horn Seligmann*, footnote 47, above.

Court of Appeals disapproved the Tax Court rule making taxability of insurance premiums depend on whether the policies were held as "security" for the husband's obligation; and found that Congress had intended the wife to be taxable under Section 22(k) only if, as a result of the husband's premium payments, she actually or constructively received property of ascertainable value.[51] The Court concluded in the *Seligmann* case that the wife's rights in the policies were too contingent to be valued, since she could receive the proceeds only if she survived the husband and failed to remarry. "Mere peace of mind or the satisfaction which stems from knowledge that protection may be of benefit in the future does not constitute taxable economic gain."

The Tax Court has adopted the Court of Appeals' approach in the *Seligmann* case,[52] and in recent decisions has uniformly held that insurance premiums were neither taxable to the wife, nor deductible by the husband, because the wife's rights in the policies were subject to various contingencies.[53]

If the husband gets behind in his periodic alimony payments, and subsequently makes a lump payment to discharge the obligations which are in arrears, the courts have held that the "arrearages retain their original character" as periodic payments and are taxable to the wife in the year of receipt.[54] The fact that the arrearages include pre-1942 delinquencies has been held immaterial, on grounds that the only significant year in the application of Section 22(k) is the year of actual receipt.[55]

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[51] The Court of Appeals in the *Seligmann* case quoted from the Senate Finance Committee Report considering the enactment in 1942 of Sections 22(k) and 23(u), to the effect that the wife's income should include only such payments as are "actually received during such taxable year (including, of course, the constructive receipt, . . . of amounts unqualifiedly subject to the demand of the wife. . . ." S. Rep. No. 1631 (77th Cong., 2d Sess.).

[52] *Leon Mandel*, 23 T.C. 81 (1954), on appeal to 7th Circuit, disallowing the husband's deductions for premiums paid in 1948 and 1949 on the same policies as to which the premiums paid in 1942 and 1943 had been held taxable to the wife, *Edna Horn Seligmann*, footnote 47, above, and deductible by the husband, *Leon Mandel*, footnote 47, above. In the second *Mandel* case, the Tax Court conceded that its former rule, placing controlling emphasis upon whether the policies were deposited as security, was too narrow; and adopted the reasoning of the Court of Appeals in *Seligmann* v. *Commissioner*, footnote 50, above.

[53] *Lilian Bond Smith*, 21 T.C. 353 (1953), acq. 1954-1 C.B. 6 (the wife was not the "owner" of the policy; the policy had not been "assigned to" her and she had acquired no right to exercise incidents of ownership therein; and her rights were contingent upon surviving the husband and failing to remarry); *Frederick Baker*, par. 54,013 Prentice-Hall Memorandum T.C. (1953) (the wife's "death or remarriage while" the husband "remains alive would terminate her rights in connection with the policies"); *Smith Estate* v. *Commissioner*, footnote 39, above, modifying on another issue par. 52,343 Prentice-Hall Memorandum T.C. (1952); *Raoul Walsh*, 21 T.C. 1063 (1954), acq. 1954-2 C.B. 6, and *Robert L. Montgomery, Jr.* T.C. Memo 1954-79 (the wife could take the insurance proceeds only by surviving the husband); *Beulah Weil*, 22 T.C. 612 (1954), supplemental opinion, 23 T.C. 630 (1955) (Tax Court stated that the controlling question was "whether Beulah either became the sole and irrevocable beneficiary of the insurance policies, or was able to realize immediate cash benefits under the policies"; and concluded that the premiums were not taxable to her because she was not "owner" of the policies; she could not change the named benficiaries; the increased cash surrender value resulting from premium payments was not available to her and "provided no immediate economic benefit to her;" and her rights would be defeated if she predeceased the husband or remarried); and *Willard H. Carr*, par. 54,050 Prentice-Hall Memorandum T.C. (1954) (if the wife predeceased the husband or remarried during his lifetime, she would receive nothing; if she survived him, she would receive only the income from the insurance proceeds during her life, after which the principal would revert to the husband's estate).

[54] *Margaret O. White*, 24 T.C. No. 51 (1955); *Grant* v. *Commissioner* (2 Cir. 1953), 209 F. 2d 430, affirming 18 T.C. 1013 (1952); *Antoinette L. Holahan*, 21 T.C. 451 (1954), affirmed (2 Cir. 1955), 222 F. 2d 82; *Narischkine Estate*, 14 T.C. 1128 (1950), affirmed (2 Cir. 1951) 189 F. 2d 257; Cf. *Elsie B. Gale*, 13 T.C. 661 (1949), affirmed (2 Cir. 1951), 191 F. 2d 79. The Service has apparently conceded the point. See Rev. Rul. 55-457, 1955 I.R.B. No. 29 (p. 14).

Section 71(c) provides generally, in substantially the same language as Section 22(k) of the 1939 Code, that "installment payments discharging a part of an obligation the principal sum of which is, either in terms of money or property, specified in the decree, instrument, or agreement shall not be treated as periodic payments." The single expressed exception is that a lump sum settlement payable in installments over a period of ten years or more will be considered a periodic payment to the extent that the payments for the taxable year do not exceed 10 per cent of the principal sum.

If a principal sum is specified and is payable over a period of less than ten years, it is immaterial that both the husband and wife intended for the payments to qualify as periodic so as to shift the tax burden to the wife.[56] Provision for fixed installments over a period of less than ten years is considered the specification of a principal sum in terms of money by the Tax Court, if such sum can be readily computed by simple arithmetic.[57] The Court of Appeals for the Ninth Circuit apparently construes the statutory term "specified" literally and requires that a principal amount actually be set out in the decree or instrument.[58]

In agreements or decrees which provide not only for periodic payments but for lump sum payments in addition thereto, it has sometimes been contended that because the total obligation is indefinite, all the payments (including the lump sum payment) are necessarily periodic. The courts, however, have held otherwise.[59] For example, a husband who agreed to pay to his wife, in addition to regular periodic alimony payments, $35,000 to buy her a house and $20,000 to pay her attorneys' bills, was not allowed to deduct the additional payments.[60] Similarly, no deduction was allowed in the case of $6,000 in payments which apparently represented a kind of agreed bonus payable to the wife in the year following her remarriage, which terminated the husband's regular alimony obligation.[61] The same result followed where one paragraph of the agreement specified a principal sum of $15,000 to be paid in $150 monthly installments, and the next paragraph required that after the full $15,000 was paid the husband would guarantee the wife an annual income of $2,400 for their joint lives.[62] In view of the foregoing, the attorney who represents the husband should resist lump sum payments in addition to agreed alimony, and should attempt to obtain the wife's consent to increased periodic payments in lieu thereof. For example, the wife might agree to purchase a house on mortgage, instead of for cash, and have alimony payments adjusted to meet the payments over the life of the mortgage.

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[55] *Antoinette L. Holahan*, footnote 54, above, where the wife unsuccessfully argued that some of the lump sum payment represented amounts which were due her in years prior to 1942 (when Section 22(k) was enacted); and that since those amounts would not have been taxable to her if they had been paid on time, they should not be taxable merely because of the delay in payment.

[56] *Clark J. Baker*, 23 T.C. 161 (1954) (divorce decree ordered payments of fifty dollars per week for five years; the Tax Court granted the Commissioner's motion to dismiss the husband's petition for failure to state a cause of action, where the petition alleged that both husband and wife had intended the payments to qualify as periodic.)

[57] *F. Ellsworth Baker*, footnote 25, above, modified on another issue (2 Cir. 1953), 205 F. 2d 369, 44 AFTR 78, *Clark J. Baker*, footnote 56, above; *Rudolf B. S. Myers*, par. 52,341 Prentice-Hall Memorandum T.C. (1952), reversed (9 Cir. 1954) 212 F. 2d 448.

[58] *Myers* v. *Commissioner* (9 Cir. 1954), 212 F. 2d 448, reversing *Rudolf B. S. Myers*, footnote 57, above.

[59] *Ralph Norton*, 16 T.C. 1216 (1951), affirmed (8 Cir. 1951) 192 F. 2d 960, 41 AFTR 439; *William M. Haag*, 17 T.C. 55 (1951); *Edward Bartsch*, 18 T.C. 65 (1952), affirmed *per curiam* (2 Cir. 1953) 203 F. 2d 715, 43 AFTR 847; *Estate of Frank C. Smith*, par. 52,343 Prentice-Hall Memorandum T.C. (1952), modified (3 Cir. 1953) 208 F. 2d 349. But cf. Judge Hastie's concurring opinion in the Smith Estate case, above, at 208 F. 2d 349, to the effect that "this refusal to read and interpret consecutive provisions in relation to each other results in an unreasonable disregard of the clear meaning of the document."

[60] *Arthur B. Baer*, 16 T.C. 1418 (1951), modified on another issue (8 Cir. 1952) 196 F. 2d 646, 41 AFTR 1227.

[61] *Jean Cattier*, 17 T.C. 1461 (1952).

Controversies involving the requirement of a periodic payment have arisen with respect to its application to agreements specifying alimony in the form of a lump sum payable in installments which may or will terminate before ten years from the date of the decree. In a close case where the divorce decree required total payments of $36,000 at the rate of $300 per month (hence a ten year period), the Court of Appeals for the Tenth Circuit has held that the payments were periodic because under the terms of the decree the final installment could be paid ten years and seven days after the decree, without being in default.[63] The Tax Court has held that payments of alimony under a decree which provided that the divorced husband was to pay $100 monthly to the wife until $9,500 was paid or until she remarried, whichever first occurred, were not "periodic payments," but installments of a principal sum.[64] Despite the fact, as argued by the husband, that the total amount which he might have to pay was indefinite, uncertain, and conditional, the court reasoned that "the word 'obligation' is used in Section 22(k) in its general sense and includes obligations subject to contingencies where those contingencies have not arisen and have not avoided the obligation during the taxable years." To the contrary, the Court of Appeals for the Second Circuit holds that " 'the principal sum . . . specified in the decree' clearly implies an amount of a fairly definite character." [65] A principal sum whose amount is contingent on the date of the wife's remarriage was not considered sufficiently definite. "Since a divorced wife's remarriage . . . depends upon some elements of her own seemingly unpredictable choosing, the computation seems as far beyond the reach of an educated guess as what will be the first name of the man or woman who will become President of the United States in 1983." The Court of Appeals for the Third Circuit has adopted the same view,[66] but the Tax Court continues to hold that the contingency of the wife's remarriage does not make the payments periodic.[67] If the view of the Court of Appeals were accepted by the Internal Revenue Service, it would greatly increase the flexibility of possible alimony arrangements available to the husband.

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[62] *S. Brad Hunt,* 22 T.C. 561 (1954).

[63] *U.S.* v. *Reis* (10 Cir. 1954), 214 F. 2d 327, 45 AFTR 1730, affirming (D.C., Kans. 1953) 1954 Prentice-Hall Federal Tax Service par. 72,422; cf. *E. L. Westhafer,* par. 53,318 Prentice-Hall Memorandum T.C. (1953) (decree required total of $12,000 in $100 monthly installments, and a modification order of the divorce court was construed as not extending the time for the final payment); *Mary Louise Williams,* par. 53,341 Prentice-Hall Memorandum T.C. (1953); *John A. Isfalt,* 24 T.C. No. 56 (1955).

[64] *J. B. Steinel,* 10 T.C. 409 (1948); see also *Frank P. Orsatti Estate,* 12 T.C. 188 (1949).

[65] *Baker* v. *Commissioner* (2 Cir. 1953), 205 F. 2d 369, reversing on this issue *F. Ellsworth Baker,* footnote 25, above.

[66] *Smith Estate,* footnote 39, above, reversing on this issue par. 52,343 Prentice-Hall Memorandum T.C. (1952) (involving three contingencies—the wife's remarriage, the husband's predeceasing the wife, and the wife's predeceasing the husband; the Court of Appeals held: ". . . there were three contingencies, the occurrence of any one of which would have relieved the taxpayer or his estate from the obligation. . . . The promise to pay was not therefore one

Where the alimony obligation is to vary with the income of the husband, taxpayers have likewise contended that the amount they might have to pay was indefinite, uncertain, and conditional. For example, in *Roland Keith Young*,[68] the agreement provided for a fixed sum of $20,000 to be paid in trust, plus monthly payments in the maximum amount of $1,000 for a period of 50 months, dependent upon the net income of the husband during the preceding year. The Tax Court held that the payments were "periodic" and, therefore, deductible. It distinguished its position with regard to an alimony obligation contingent upon the wife's remarriage on the ground that if payments are dependent upon the husband's future annual income neither the total amount taxable nor the amount of each payment represents a fixed sum. The Tax Court reached the same result in *John H. Lee*[69] which involved a similar arrangement based upon varying percentages of the husband's net income over a period of five years. In *James M. Fidler*,[70] however, the Tax Court has stated that both of the foregoing decisions are to be limited to their special facts. Under the decree in the *Fidler* case payments were to vary between a maximum of $800 and a minimum of $500 per month and were to be paid over a period of four years and five months. The size of the possible $300 differential was to vary directly with the husband's annual income as a radio performer. The Tax Court nevertheless held that the entire $800 payment represented an installment of a specified principal sum, but the Court of Appeals for the Ninth Circuit agreed that $500 per month was installment but held the $300 to be periodic because subject to contingencies.

In *Clay W. Prewett, Jr.*,[71] the decree called for payments of $270 per month for two years but provided that the payments should be reduced in the event of a "material reduction" in the husband's earning capacity. Although the monthly payments were actually decreased to $200 with the wife's consent, the Tax Court decided there was a failure of proof that such decrease was caused by a material reduction in earning capacity. The Court of Appeals for the Eighth Circuit reversed, allowing the husband a deduction.

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which could be mathematically calculated as a certain obligation of the husband." Query, if the only contingency which could terminate the payments were the wife's predeceasing the husband, would the Third Circuit reach the same result? Cf. *Myers* v. *Commissioner*, footnote 58, above. More recent decisions are in accord. *Prewett* v. *Commissioner* (8 Cir. 1955), 221 F. 2d 250, reversing 22 T.C. 270 (1954); *Davidson* v. *Commissioner* (9 Cir. 1955), 219 F. 2d 147, modifying par. 52,326 Prentice-Hall Memorandum T.C. (1952).

[67] *Clay W. Prewett, Jr.*, 22 T.C. 270 (1954) reversed, *Prewett* v. *Commissioner*, footnote 66, above; *John A. Isfalt*, footnote 63, above.

[68] 10 T.C. 724 (1948), acq. 1948-2 C.B. 4.

[69] 10 T.C. 834 (1948), acq. 1948-2 C.B. 3. See *Frank J. Loverin*, 10 T.C. 406 (1948), where a deduction was denied for an $8,500 lump sum settlement of a prior concededly periodic payment obligation of $60 weekly.

[70] 20 T.C. 1081 (1953), after the Tax Court had vacated par. 52,332 Prentice-Hall Memorandum T.C. (1952), modified (9 Cir. 1955) 1955 P-H Federal Tax Service, par. 72,478; cf. *F. Ellsworth Baker*, footnote 25, above; *Clay W. Prewett, Jr.*, footnote 67, above.

[71] Footnote 67, above.

The date at which the ten-year period under the statute begins to run was involved in *Tillie Blum.*[72] In that case, if the period began at the date of the settlement agreement, the installment payments would extend over a period of ten years and, therefore, would qualify as "periodic payments." On the other hand, if the period began at the date the decree was recorded, the payments would not extend for the necessary ten years and would not qualify as "periodic payments." The agreement was executed before the decree, but it provided that it should "become effective" only when and if the decree was recorded. The Tax Court felt that the date of the decree, as the "effective date" of the agreement, was determinative, and it held that the payments were not periodic and, hence, were not includible in the wife's income. The Court of Appeals has reversed the Tax Court, holding that under these circumstances the date of execution of the agreement begins the running of the period.

d. The payments must be in discharge of a legal obligation arising from the marital relationship. Section 71(a)(1), like Section 22(k) of the 1939 Code, requires that the payments be made for the discharge of a legal obligation imposed upon the husband as a result of the marital relationship. To qualify under Section 71(a)(2), however, it is sufficient if the payments under the written separation agreement are made "because of the marital or family relationship," no legal obligation being required. The possible significance of this difference in language has been noted above.[73] Application of Section 71(a)(3) is restricted to court decrees for support or maintenance, and so, while the section does not expressly state that the payments must be in discharge of a legal obligation imposed as a result of the marital relationship, the effect is apparently the same.

The question has been raised whether payments by the husband for the support of the wife's mother would satisfy the requirement of arising from the marital relationship. The Tax Court has held that such payments are taxable to the wife and deductible by the husband, likening them to the wife's payments to her landlord or her grocer, which the husband might be required to bear as a part of his general obligation of support.[74] Similarly, payments may be taxable to the wife under Section 71(a) although made not by the husband but, for example, by his father,[75] or his corporation,[76] where it is clear that the husband's support or alimony obligation is being discharged. It is also unimportant that the payments would not be defined as "alimony" under California law, because they were to be continued after the wife's remarriage.[77]

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[72] 10 T.C. 1131 (1948), reversed (7 Cir. 1951), 187 F. 2d 177, 40 AFTR 266, cert. den. 342 U.S. 819 (1951).

[73] See footnotes 18 and 19, above.

[74] *Robert Lehman,* 17 T.C. 652 (1951), appeal to 2 Cir. dismissed June 18, 1952; *Ruth Lamar Lehman,* T.C. Memo. 1955-229.

[75] *Luckenbach* v. *Pedrick* (D.C. S.D. N.Y. 1953), 116 F. Supp. 268, affirmed (2 Cir. 1954), 214 F. 2d 914 (noting that the father would have a right of subrogation against the husband, but holding that it was immaterial whether the husband had actually reimbursed the father for the payments.)

[76] *Marcia P. Pierson,* 21 T.C. 826 (1954) (part of the corporate payments were offset against the husband's salary, but the Tax Court held "It is of no concern to her or to us in this proceeding whether her former husband repaid the Company.").

[77] *Brown* v. *U.S.* (D.C., N.D. Calif. 1954), 121 F. Supp. 106 (findings and conclusions), 1954 Prentice-Hall Federal Tax Service par. 72,483 (opinion) (". . . the deductibility of payments under Sections 22(k) and 23(u) does not depend upon how they are characterized by state law.")

The Tax Court has recently held that the Code's alimony provisions were not applicable where the husband was required by separate maintenance decree to pay $185 per month for the wife's support, but under California law the separate maintenance decree did not destroy the wife's interest in the parties' community property. Under these circumstances, the Court ruled that since the wife would continue to be taxable on one-half of the husband's earnings because of her community interest, she "cannot be taxed again when a part of that income is placed under her exclusive control pursuant to a decree for support and maintenance." [78]

It is clear that Section 71(a) does not apply to the repayment of a loan to the wife, payments in consideration of the release of her interest in community property, a return of money she had invested in a business enterprise, or to any similar amount which is payable to her pursuant to an obligation which does not arise "because of the marital or family relationship." [79] Moreover, any payments made voluntarily by the husband not pursuant to a legal obligation, even though subsequent to the divorce decree, will not qualify under Section 71(a)(1). Thus it has been held under Section 22(k) of the 1939 Code that increased amounts paid by the husband to the wife after the divorce were not deductible by him and taxable to her, because they were not in discharge of a legal obligation resulting from the marital relationship.[80] As discussed above, a different conclusion may be reached under Section 71(a)(2), if that section is held to apply in the case of a written agreement executed *after* divorce.[81] The increased payments have been held by the Tax Court to retain their voluntary character although the original decree was modified retroactively to incorporate such payments,[82] while the Court of Claims has allowed a deduction for increased payments under an agreement wherein the husband and wife compromised an action which had been instituted by the wife to have a Nevada decree modified.[83]

As the obligation must arise from the marital relationship, questions naturally may arise whether, in the event the husband dies before the wife, and the payments to her are continued following his death, such payments are deductible by the estate. The question was passed upon in *Estate of Homer Laughlin.*[84] In that case the Court of Appeals reversed the Tax Court and permitted the estate to deduct the payments made under Section 162(b) of the 1939 Code, relating to deductions of estates and trusts. The estate conceded, and the Court of Appeals agreed, that the estate was not entitled to a deduction under Section 23(u) of the 1939 Code which, like Section 215 of the 1954 Code, applied only to payments made during the husband's lifetime.

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[78] *Marjorie Hunt,* 22 T.C. 228 (1954), acq. 1954-2 C.B. 4 (noting that in 1951 the California law was amended to provide that after a separate maintenance decree the earnings of each party become separate property) cf. *Cecile D. Freundlich,* T.C. Memo, 1955-177.

[79] Reg. 118, § 39.22(k)-1; see *Campbell* v. *Lake* (5 Cir. 1955), 220 F. 2d 341, reversing (D.C. N.D. Tex 1953), 45 AFTR 880; *Frank J. DuBane,* 10 T.C. 992 (1948); *Julia Nathan,* 19 T.C. 865 (1953); *Landa* v. *Commissioner* (App. D.C. 1954), 211 F. 2d 46, reversing par. 53,239 Prentice-Hall Memorandum T.C. (1953), on remand from par. 52,119 Prentice-Hall Memorandum T.C. (1952), reversed (App. D.C. 1953) 206 F. 2d 431; *Corinne Pope Thompson,* 22 T.C. 275 (1954); *Miriam Finiley Schwartz,* T.C. Memo. 1954-54.

[80] *Frederick S. Dauwalter,* 9 T.C. 580 (1947), appeal to 2 Cir. dismissed February 2, 1948; *George R. Joslyn,* 23 T.C. 126 (1954); on appeal to 7th Cir.; *Frank J. Loverin,* footnote 69, above; cf. *Dorothy Briggs Smith,* 16 T.C. 639 (1951), affirmed (1 Cir. 1951) 192 F. 2d 841, 41 AFTR 418; *Newton* v. *Pedrick,* footnote 18 above.

[81] See footnotes 14, 19, and 20, above.

[82] *Peter van Vlaanderen,* 10 T.C. 706 (1948), affirmed (3 Cir. 1949) 175 F. 2d 389, 38 AFTR 75; *Donald B. Semple,* par. 51,263 Prentice-Hall Memorandum T.C. (1951); see also *Ned* and *Ethel R. Fuller,* par. 49,244 Prentice-Hall Memorandum T.C. (1949).

[83] *DuPont* v. *U.S.* (Ct. Cls. 1952), 104 F. Supp. 978. *A fortiori,* arrearages in payments retroactively increased pursuant to a Court decree in an action instituted by the wife have been held taxable when paid to her in a lump sum despite her contention that such payment is not "periodic" in nature. *Gale* v. *Commissioner,* footnote 54, above. Moreover, if, under a decree, the husband makes payments of alimony after the wife's remarriage, but prior to the retroactive modification of such decree designating the payments as being for the support of minor children, the payments have been ruled deductible by him and taxable to the wife. I.T. 4108, 1952-2 C.B. 113; compare footnote 113, below.

e. The obligation must be imposed under the decree or under a written instrument incident to the divorce or separation. Sections 22(k) and 23(u) of the 1939 Code were applicable only where the husband's payments were pursuant to an obligation imposed upon him under (1) a decree or (2) a written instrument "incident" to the divorce or separation. Section 71(a)(1) of the 1954 Code contains the same limitations. Section 71(a)(3) applies only where the payments are made pursuant to a decree. Section 71(a)(2) represents the greatest departure from the 1939 Code provisions, in requiring neither a decree nor an instrument incident to the divorce or separation but, in lieu thereof, a written separation agreement. As suggested earlier, the importance of Section 71(a)(2) will depend upon how broadly it is construed, in its application to situations where the parties are divorced or legally separated under decree of separate maintenance. If, for example, Section 71(a)(2) is ultimately interpreted to have broad application to such situations, then it and not Section 71(a)(1) will be of prime importance in tax planning for divorced parties, since the necessity of proving that the agreement is "incident to" the divorce would for practical purposes be eliminated.

Under Section 71(a)(1) the parties may rely upon an agreement, which naturally must be in writing. Although it may create a binding contract enforceable under applicable state law, an oral agreement was held not sufficient for purposes of Section 22(k).[85] However, it has been held that the requirement of a written instrument may be satisfied by informal correspondence between the parties.[86] The same rules probably should apply to the "written separation agreement" required by Section 71(a)(2).

The Tax Court has recently changed its view concerning the requirement that the instrument be "incident to such divorce or separation." The provision was formerly interpreted as requiring that the instrument be incident to the divorce or separate maintenance "decree."[87] In *Raoul Walsh,*[88] however, the Tax Court has decided that it is sufficient that the instrument be incident to the "status"[89] of divorce or legal separation, rather than to the "decree." In the *Walsh* case, an agreement executed thirteen years after entrance of the divorce decree revised and cancelled a pre-divorce agreement but was nevertheless held "incident to" the divorce. The Court reasoned that "Since the 1927 [pre-divorce] agreement was incident to a divorce, the subsequent 1941 agreement, though cancelling the earlier agreements, constituted a revision and reappraisal of the parties' position by altering terms only and this agreement was also 'incident to a divorce' under section 22(k)." The Commissioner has noted his acquiescence in the *Walsh* decision.[90] Accordingly, prior cases considering the meaning of "incident to such divorce or separation" may have more historical interest than practical importance.

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[84] (9 Cir. 1948), 167 F. 2d 828, 36 AFTR 985; G.C.M. 25999, 1949-1 C.B. 116. The Court held the payments deductible notwithstanding the Commissioner's argument that the commuted value of the claim was deductible for estate tax purposes and, therefore, a double deduction should be denied under 1939 IRC § 162(e) and Reg. 111, § 29.162-1. The Tax Court, following the decision in the *Laughlin* case, has held that similar payments by the estate are taxable to the wife under 1939 IRC § 22(k). *Helen Scott Fairbanks,* 15 T.C. 62 (1950), affirmed (9 Cir. 1951), 191 F. 2d 680, 40 AFTR 1230, cert. den. 343 U.S. 915 (1952); *Margaret C. Izrastzoff,* 15 T.C. 573 (1950), affirmed (2 Cir. 1952), 193 F. 2d 625, 41 AFTR 630; *Daisy M. Twinam,* footnote 1, above. Cf. Rev. Rul. 55-457, footnote 54, above.

[85] *Ben Myerson,* 10 T.C. 729 (1948).

[86] *Charles Campbell,* 15 T.C. 355 (1950), acq. 1951-1 C.B. 1.

[87] *Commissioner* v. *Walsh* (App. D.C. 1950), 183 F. 2d 803, 39 AFTR 801, affirming 11 T.C. 1093 (1948), nonacq. 1949-1 C.B. 7; but cf. *DuPont* v. *U.S.,* footnote 83, above; *Smith*

It had been held that where a later agreement purports merely to clarify, supplement, or modify an earlier agreement which concededly was incident to the divorce, the later agreement was also "incident to" the divorce.[91] Under this rule, modification agreements entered into twenty,[92] nineteen,[93] seventeen,[94] and six[95] years after the decree, had been held incident to the divorce. Again, following a 1937 agreement incident to divorce, where the decree fixed monthly payments to the wife both for her support and for support of the children but expressly noted that final decision as to the wife's right to payments after the children reached their majority was to be made later, a modification for this purpose in 1944, after the youngest child reached twenty-one, had been held "incident to" the divorce.[96] A written instrument formally executed a few days after a divorce, pursuant to a prior oral agreement that such instrument would be executed if divorce was granted, had also qualified as a written instrument "incident to" the divorce.[97]

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v. *Commissioner*, footnote 80, above; *Commissioner* v. *Murray* (2 Cir. 1949), 174 F. 2d 816, 37 AFTR 1517.

[88] Footnote 53, above, reviewed by the Court, disapproving *Commissioner* v. *Walsh*, footnote 87, above (which had reached an opposite conclusion with respect to the same agreement, as to payments made thereunder in earlier years).

[89] The present Tax Court view finds support in *DuPont* v. *U.S.*, footnote 83, above; *Smith* v. *Commissioner*, footnote 80, above; *Commissioner* v. *Murray*, footnote 87, above; *Lerner* v. *Commissioner* (2 Cir. 1952), 195 F. 2d 296, 41 AFTR 910, reversing 15 T.C. 379 (1950); and *Newton* v. *Pedrick*, footnote 18, above.

[90] 1954-2 C.B. 6.

[91] *Helen Scott Fairbanks*, footnote 84, above; *Rowena S. Barnum*, footnote 19, above; *Mahana* v. *U.S.* (Ct. Cls. 1950), 88 F. Supp. 285, 38 AFTR 1446, cert. den. 339 U.S. 978 (1950); *DuPont* v. *U.S.*, footnote 83, above. But where the later agreement created an alimony or other obligation which the husband did not have under the original decree, the payments have been held not covered by 1939 IRC §§ 22(k) and 23(u). *Emanuel Alboum*, par. 51,008 Prentice-Hall Memorandum T.C. (1951).

[92] *Antoinette L. Holahan*, footnote 54, above.

[93] *Rowena S. Barnum*, footnote 19, above.

[94] *Grant* v. *Commissioner*, footnote 54, above (the Court of Appeals holds that even though the subsequent agreement may, under the law of contracts, be considered entirely separate from the earlier agreement, the law of contracts must "yield to the purposes of the revenue statutes.").

[95] *Newton* v. *Pedrick*, footnote 18, above (like the *Walsh*, footnote 88, above and *Grant*, footnote 54, above, cases, the later agreement in *Newton* v. *Pedrick* was an entirely separate agreement, but the Court of Appeals held that the series of agreements involved nothing but "successive reshufflings of the total original divorce arrangements" and therefore the later agreement was held "incident to" the divorce).

[96] *Dorothy Briggs Smith*, footnote 80, above.

[97] *Frank J. DuBane*, footnote 79, above.

Although the government has contended that an agreement executed before the divorce is not "incident" thereto where the decree does not refer to the agreement, the cases have held the contrary.[98] To avoid risk of litigation, of course, it would be advisable for the divorce decree to incorporate or refer to the written instrument. If that procedure is not possible or feasible, the parties may consider including in the agreement some mention of a divorce to be obtained in the future. It has been contended that under the law of certain states mention of the possibility of divorce in a separation agreement is impossible as a practical matter because of the risk that charges of collusion in obtaining the divorce may be brought against the parties.[99] The Tax Court has held the agreement a written instrument "incident to" the divorce, where the husband has established that this was the reason for neglecting the aforementioned precautions.[100] The wife's cooperation in establishing this fact is naturally a difficult thing to obtain, since, if the husband fails in his proof, she stands to gain by escaping tax on the alimony payments and shifting this tax burden to the husband.

The Tax Court's announcement, in the *Walsh* case, that an instrument incident to the "status" of divorce may qualify although not incident to the "decree," might be thought to indicate that the Tax Court will no longer require proof that both parties contemplated a divorce at the time the instrument was executed. In more recent cases, however, the Tax Court has continued to refer to the mutual contemplation test.[101] A separation agreement, as held by the Court of Appeals for the

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[98] *Robert Wood Johnson*, 10 T.C. 647 (1948), acq. 1948-2 C.B. 2; see *Benjamin B. Cox*, 10 T.C. 123 (1948), affirmed (3 Cir. 1949), 176 F. 2d 226, 38 AFTR 301; *Thomas E. Hogg*, 13 T.C. 361 (1949), nonacq. 1950-1 C.B. 7; *George Brady*, 10 T.C. 1192 (1948), acq. 1948-2 C.B. 1; *Estate of Daniel G. Reid*, 15 T.C. 573 (1950), affirmed (2 Cir. 1952), 193 F. 2d 625; *Bertram G. Zilmer*, 16 T.C. 365 (1951), acq. 1951-1 C.B. 3.

[99] In a Note, "Taxation of Support Payments to a Divorced Spouse Under Private Agreement," *Yale Law Journal*, 1952, Vol. 61, page 1198, 1203, this contention is questioned as possibly based on a misconception of local law, in some states at least.

[100] *Bertram G. Zilmer*, footnote 98, above; see also *Charles Campbell*, footnote 86, above, at 15 T.C. 360 (1950).

[101] *Robert L. Montgomery*, footnote 53, above; *Harold Holt*, 23 T.C. 469 (1954), reversed (2 Cir. October 25, 1955). Under the facts stipulated in the *Walsh* case, footnote 53, above, the earlier agreement "was entered into because the parties intended to be divorced." Hence the Tax Court in that case did not directly consider whether it would continue to require mutual contemplation of divorce. But the Court quoted, apparently with approval, from the Court of Appeals' opinion in *Lerner* v. *Commissioner*, footnote 89, above, to the effect that ". . . where the payments obviously take the place of alimony . . . although not formally incorporated into the decree, they should not be denied effect under the statute merely because there is no evidence that divorce and settlement were not contemporaneously planned and carried out." Prior to the *Walsh* case, the Tax Court allowed the husband alone to prove the intent of the parties in a case where the agreement provided that the husband's payments be held in escrow pending the entry of a divorce decree, and where the wife established legal residence in Nevada twelve days thereafter. *Elizabeth E. Guggenheim*, 16 T.C. 1561 (1951). The Tax Court's new approach, recognizing instruments incident to the "status" of divorce, may conceivably affect the situation where a court order for support payments in one state is immediately followed by suit by one of the spouses for a Nevada divorce, where the Nevada decree does not mention the support order. *S. B. Tressler*, par. 53,111 Prentice-Hall Memorandum T.C. (1953); *Ray W. Droke*, par. 53,219 Prentice-Hall Memorandum T.C. (1953); *W. L. H. Bergen*, par. 51,272 Prentice-Hall Memorandum T.C. (1951). Support payments under such court orders have been considered by the Tax Court as neither payments under a decree of divorce, nor under an agreement incident to such divorce. Of course, payments made under these circumstances should now qualify for treatment under Section 71(a)(3) of the 1954 Code, if that section is held to apply to payments made after divorce. The problem is discussed earlier in this Chapter.

Second,[102] Third,[103] and Ninth[104] Circuits, may be incident to divorce if the proof establishes that one of the parties actively contemplated divorce at the time of the agreement.[105]

f. Payments for the support of minor children. Neither Section 71 nor Section 682 applies to that part of any periodic payment which, by the terms of the decree, instrument or agreement, is specifically designated as a sum payable for the support of minor children of the husband.[106] This limitation is equally applicable to payments under Sections 71(a)(1), (2), and (3). Thus, in the illustrative case, even though the parties understand that a part of the payments made to the wife is for the support of the minor children, the entire amount will be includible in her income and deductible by the husband from his gross income, if the decree or agreement does not specify the part of the payments intended for the children's support.[107] The $50 per month payable to the mother, moreover, would be taxable to the wife, even though the amount is specifically designated.[108]

The decree or instrument is to be read as a whole in determining whether there has been an amount specified for the support of minor children. Consequently, ambiguity should be avoided in drafting the agreement. For example, in *Robert W. Budd,*[109] the agreement provided that the wife should be paid $500 per month for the support of herself and her minor son. In the event of the wife's remarriage, payments of $200 were to be made for the support of the son. When the son reached twenty-one, or upon his death, the wife was to be paid $300 per month for her support until she remarried. It was held that, under the agreement read as a whole, the amount of $200 per month was specified for the support of the minor child and was consequently not deductible by the husband, although he actually paid $500 per month during the years involved.

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[102] *Izrastzoff* v. *Commissioner,* footnote 84, above; *Lerner* v. *Commissioner,* footnote 89, above; *Commission* v. *Moses* (2 Cir. 1954), 214 F. 2d 912, reversing 18 T.C. 1020 (1952); *Moses Est.* v. *Commissioner* (2 Cir. 1955), 1955 Prentice-Hall Federal Tax Service par. 72,711, vacating par. 53,225 Prentice-Hall Memorandum T.C. (1953); *Holt* v. *Commissioner* (2 Cir. October 25, 1955), reversing *Harold Holt,* footnote 101, above.

[103] *Feinberg* v. *Commissioner,* footnote 35, above.

[104] *Commissioner* v. *Miller* (9 Cir. 1952), 199 F. 2d 597, 42 AFTR 738, reversing 16 T.C. 1010 (1951).

[105] Cf. *Stewart* v. *Rothensies* (D.C., E.D. Pa. 1953), 114 F. Supp. 497 (French divorce followed separation agreement by five months, and the terms of the agreement provided that it would continue in effect after divorce. In holding the agreement incident to divorce, the Court stated: "It is settled law, we think, that the expression 'incident to divorce' appearing in § 22(k) does not require that there be anticipation or contemplation of divorce by *either* the husband or wife at the time the separation agreement was entered into."). In *Frances Hamer Johnson,* 21 T.C. 371 (1953), acq. 1954-1 C.B. 5, the Tax Court held an agreement not incident to a divorce obtained two years later, finding that *neither* party had contemplated divorce when the agreement was executed.

[106] Sections 71(b) and 682(a), corresponding to Sections 22(k) and 171(a) of the 1939 Code.

[107] Reg. 118, § 39.22(k)-1; *Dora H. Moitoret,* 7 T.C. 640 (1946). If this result is desired the proposed provision covering support for the children in the event of the wife's remarriage in the illustrative case should be avoided. See footnote 109, below.

[108] Reg. 118, § 39.22(k)-1(d); *Robert Lehman,* footnote 74, above.

[109] 7 T.C. 413 (1946), affirmed *per curiam* (6 Cir. 1947) 177 F. 2d 198, 38 AFTR 549. The Court reached similar results in *Warren Leslie, Jr.,* 10 T.C. 807 (1948); *Benjamin Davidson,* par. 52,326 Prentice-Hall Memorandum T.C. (1952), modified *Davidson* v. *Commissioner,* footnote 66, above; *Charles B. Hicks,* par. 53,216 Prentice-Hall Memorandum T.C. (1953); *William E. MacKay,* par. 54,032 Prentice-Hall Memorandum T.C. (1954); *Malcolm Neuwahl,* T.C. Memo. 1954-100; *Alpheus M. Ball,* T.C. Memo. 1955-84; *Saxe Perry Gantz,* 23 T.C. 576 (1954). Somewhat dissimilar results were reached in *Elsa B. Chapin,* par. 47,224 Prentice-Hall Memorandum T.C. (1947); *Warren Newcombe,* par. 51,045 Prentice-Hall Memorandum T.C. (1951), affirmed (9 Cir. 1953), 203 F. 2d 128, 43 AFTR 648; and *Henrietta S. Seltzer,* 22 T.C. 203 (1954). See also *Robert K. McBerty,* 16 T.C. 968 (1951), acq. 1951-2 C.B. 3; *Jason R. Swallen,* par. 51,149 Prentice-Hall Memorandum T.C. (1951); *Beulah Weil,* footnote 53, above and supplemental opinion, 23 T.C. 630 (1955); and *George R. Joslyn,* footnote 80, above, involving special fact situations.

The question has arisen whether payments designated for support of the children and therefore not taxable to the wife so long as the children remain minors, nevertheless become taxable to her if such payments are continued after the children reach their majority. In *Leon Mandel,*[110] where the husband had an option, under the agreement, to make the payments direct to the children but chose to make them to the wife, the Tax Court refused to hold the wife taxable on the amounts received. While the decision was based at least partly on the ground that Congress could not have intended that the husband, through a failure to exercise his option, should impose tax liability on the wife at his discretion, the Court stated: "Moreover, we cannot believe Congress ever intended that payments to children throughout their lives, such as those here in question, even though provided for in a written agreement incident to divorce, should be taxable to the wife."

When an amount or portion is specified for the support of minor children, a partial payment will be first applied against the amount specified for the support of the minor children; only the remainder will be deductible by the husband.[111] For example, if the decree requires the husband to make payments to his wife of $100 per month for her support and $50 per month for support of their minor child, and the husband actually pays only $100 to his wife, $50 is nevertheless considered to be paid for support of the child, and only the remaining $50 is taxable to the wife and deductible by the husband.[112]

In three recent decisions,[113] the Tax Court has considered the effect of a *nunc pro tunc* order of the divorce court designating a specific portion of the husband's payments to be for support of the children. In each case, the original divorce decree did not designate a portion of the payment as being for the support of the children, but in a subsequent year the divorce court reformed the decree to specify the portion intended for such support. The Tax Court held that the later court orders had the effect of changing the divorce decrees *ab initio*, and that the amounts designated for support in the corrective orders were not taxable to the wives.

The question regarding credit for dependency, with respect to the children, turns upon who is taxable on the amounts expended for their support. Thus, payments that are fully taxable to the wife under the terms of either Sections 71 or 682 but are used for the support of the children, are considered payments by her for such support and not payments by the husband.[114]

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[110] Footnote 52, above.

[111] 1954 IRC § 71(b); 1939 IRC § 22(k); Reg. 118, § 39.22(k)-1.

[112] *Martha J. Blyth,* 21 T.C. 275 (1953), acq. 1954-1 C.B. 3; *George R. Joslyn,* footnote 80, above; *Beulah Weil,* 23 T.C. 630 (1955).

[113] *Saxe Perry Gantz,* 23 T.C. 576 (1954); *Margaret Rice Sklar,* 21 T.C. 349 (1953), nonacq. 1954-1 C.B. 9; *Velma B. Vargason,* 22 T.C. 100 (1954), *nonacq.* 1955 I.R.B. No. 5 (p. 6); but cf. *Edna M. Gilbertson,* par. 51,192 Prentice-Hall Memorandum T.C. (1951); cf. footnote 82, above.

[114] 1954 IRC § 152(b)(4); 1939 IRC § 25(b)(3); Reg. 118, § 39.25-4; *Richard P. Prickett,* 18 T.C. 872 (1952).

As the husband ordinarily cannot prove that he contributed over half the support of any child in the wife's custody, without the cooperation of the wife, his prospects of being allowed the dependency credit are slim even where the amount intended for the support of the children is specified in the decree and so is not deductible by him.[115] It has been held, moreover, that lump sum payment of arrearages for prior years do not take the character of support payments for either the current year[116] or the prior years,[117] for the purpose of determining whether the husband has contributed over half of the support of the children.

If the husband and wife are divorced or legally separated under a decree of separate maintenance, the parent having custody of one or more of the children may qualify as a "head of household" and be entitled to compute his or her income tax liability under the table provided in Section 1(b) of the 1954 Code. To qualify as a "head of household," it is necessary that the parent not be married at the close of the taxable year,[118] and that the parent furnish more than half the cost of maintaining a household in which the parent and such children reside.[119]

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[115] In most of the cases on this point in recent years the husband has been disallowed the credit for failure of proof. *Allie Norwood Root,* par. 53,015 Prentice-Hall Memorandum T.C. (1953); *Victor A. Pietrowski,* par. 53,138 Prentice-Hall Memorandum T.C. (1953); *Joseph P. Rinnert,* par. 53,205 Prentice-Hall Memorandum T.C. (1953); *Alfred Campbell,* par. 53,218 Prentice-Hall Memorandum T.C. (1953); *Charles B. Hicks,* footnote 109, above; *Ray W. Droke,* footnote 101, above; *Forest L. Wendel,* par. 54,020 Prentice-Hall Memorandum T.C. (1954); *Howard R. Moore,* par. 54,041 Prentice-Hall Memorandum T.C. (1954); *Frank E. McDevitt,* par. 54,068 Prentice-Hall Memorandum T.C. (1954); *George E. Christiansen,* par. 54,071 Prentice-Hall Memorandum T.C. (1954); *Mario H. DeSalvo,* par. 54,101 Prentice-Hall Memorandum T.C. (1954); *Edward J. Blondsey,* T.C. Memo. 1954-6; *Edwin J. Barrett,* T.C. Memo. 1954-49; *Sid Dyer,* T.C. Memo. 1954-65, and T.C. Memo 1955-168; *Daniel U. Dunaway,* T.C. Memo. 1954-108; *Francis J. Pott,* T.C. Memo. 1954-130; *Stanley H. Saurs,* T.C. Memo. 1954-149; *Wayman* v. *U.S.* (D.C. E.D. Ky. 1954), 1954 Prentice-Hall Federal Tax Service par. 72,745; *Harry Zippin,* par. 53,340 Prentice-Hall Memorandum T.C. (1953); *Medford J. Campbell, Sr.,* T.C. Memo. 1955-102; *Bernard T. Weidler,* T.C. Memo. 1955-130; *Clarence R. Claus,* T.C. Memo 1955-143; *Gervase A. Kessler,* T.C. Memo. 1955-203; *Leo Joseph Rozek,* T.C. Memo. 1955-267; and *Edward Goldblatt,* T.C. Memo. 1955-272. The husband was allowed the credit in *Alfred G. Andrews,* par. 53,169 Prentice-Hall Memorandum T.C. (1953); *Howard R. Moore,* par. 54,041 Prentice-Hall Memorandum T.C. (1954); *Vernon W. Rennick,* T.C. Memo. 1954-17; *William L. Leino,* par. 53,409 Prentice-Hall Memorandum T.C. (1953); *David E. Sauer,* par. 53,394 Prentice-Hall Memorandum T.C. (1953); *Jerome DeLeonardis,* T.C. Memo. 1955-140; *Sid Dyer,* T.C. Memo. 1955-168; *Claude Blankenship,* T.C. Memo. 1955-169; *Robert Thomas,* T.C. Memo. 1955-188; *Charles S. Weil,* T.C. Memo. 1955-242; and *Francis Thompson,* T.C. Memo. 1955-266. Recent cases involving the wife's right to the credit are *Martha J. Blyth,* footnote 112, above (credit disallowed); *Frances Strinsky Spriggs,* par. 54,079 Prentice-Hall Memorandum T.C. (1954) (credit allowed); *Gloria H. Waggoner,* T.C. Memo. 1954-53 (credit disallowed for 1949 but allowed for 1950); and *Marion M. Bevan,* T.C. Memo. 1955-85 (credit allowed).

[116] *Thomas Lovett,* 18 T.C. 477 (1952), acq. 1952-2 C.B. 2; *Alfred Campbell,* footnote 115, above; Rev. Rul. 220, 1953-2 C.B. 22.

[117] Rev. Rul. 220, footnote 116, above.

[118] Section 1(b)(3)(B) provides that "an individual who is legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married."

[119] Under the head of household provisions, "in the case of his own children, the taxpayer need not support the children . . . so long as the taxpayer supplies more than half the cost of maintaining the home." S. Rep. No. 1622 (83d Cong., 2d Sess.) page 5. Section 2 of H.R. 8300, as originally drafted in the House of Representatives, would have permitted the divorced father to qualify as "head of family" and receive the same income splitting benefits as are available under a joint return, if the father furnished more than half the support of his children, even though they lived with the mother. H. Rep. No. 1337 (83d Cong., 2d Sess.) page 5. The Senate substantially restored the head of household provisions under 1939 IRC § 12(c). Various recommendations which have been considered are summarized in the

3. Alimony Payments Attributable to Transferred Life Insurance, and Endowment and Annuity Contracts

Payments received by a wife, which are attributable to transferred property represented by life insurance, endowment, or annuity contracts, present a host of troublesome problems.

Section 71(a)(1) provides that periodic payments received after a decree of divorce or separate maintenance, which are "attributable to property transferred, in trust or otherwise," in discharge of the husband's legal obligation under the decree or under a written instrument incident thereto, shall be included in the gross income of the wife. The same result follows under Section 71(a)(2), where the property is transferred under a written separation agreement and "because of the marital or family relationship." As has been noted above, however, Section 71(a)(3) does not contain a similar provision, and therefore it appears that if the transferred property discharges the husband's obligation under a *support* decree as distinguished from a decree of divorce or of separate maintenance, the wife will not be taxable under Section 71(a)(3) on account of payments attributable to such property.[120] Under Section 71(d), amounts taxable to the wife because attributable to transferred property under subsection (a), are excluded from the gross income of the husband.

The Regulations under the corresponding provisions of the 1939 Code state that the above results follow regardless of whether such payments are "attributable to property in trust, to life insurance, endowment, or annuity contracts, or to any other interest in property, or are paid directly or indirectly by the obligor husband from his income or capital." [121]

In providing for taxation of such payments to the wife, even though paid from capital, these provisions subject otherwise untaxable amounts to an income tax. In the case of an unfunded alimony payment, that is, one paid to the wife directly by the husband from his own income, the amount taxable to the wife will offset the amount deductible by the husband. However, in the case of periodic alimony payments that are funded, that is, payments of income or principal that come from property transferred by the husband, the entire amount paid to the wife is taxable to her; but the husband is not entitled to any deduction. It is true, of course, that the husband will be allowed to exclude from his gross income the in-

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following report: ". . . a number of requests for relief, together with some recommendations, are before the men drafting the 1954 tax revision bill. . . . it has been proposed that payments for the support of minor children be made deductible by the husband and taxable to the wife. Against this proposal is the contention that the wife might contend successfully that such payments do not constitute gross income to her. One of the difficulties arising under the present situation relates to the credit for dependents. . . . One recommendation is that a proportionate allocation of the credit between husband and wife be permitted. Another suggestion is that the allowance of a deduction for payments for support of minor children would remove the difficulty. In such a case the wife presumably would be required to include the payments in her income and would then be entitled to the full dependency credits. It is also suggested that such a solution would remove the existing inequity of denying head-of-household treatment to the father." (Bureau of National Affairs "Daily Report for Executives," October 15, 1953, page G-1).

[120] Footnote 6, above.

[121] Reg. 118, § 39.22(k)-1(b).

come paid to the wife from the property transferred. In such case there is no cause for complaint, so long as the payments received are income from property which otherwise would have been taxable to the husband, because this treatment merely results in a shifting of the tax on this same amount of income from the husband to the wife. Where the payments received are from "capital," however, income subject to tax in the hands of the wife is created, which would not have been income subject to tax in the ordinary case. For example, if the husband in the illustrative case, were to purchase for $90,000 an annuity of $300 per month to be paid to his wife, he would not obtain any deduction for any part of this $90,000. The wife would, however, be taxed on the full $3,600 annually received by her.[122] Apart from the above provisions of the Code, assuming for example that the husband was 45 years of age at the "annuity starting date" and that the annuity does not have a refund feature, the husband purchasing the annuity would have been subject to tax on only $576 [123] and the wife would not be subject to any tax. Thus, the purchase of the annuity would result in the husband and wife together being taxed on $3,024 more each year than they otherwise would have been.

The same result follows from periodic payments attributable to property transferred in trust. The full amount of periodic payments paid by the trustee to the wife is includible in the wife's income and excluded from the husband's income, notwithstanding the fact that such payments may have been made out of trust corpus or principal. To the extent that such payments are made out of principal in such case, the parties, as indicated above, are subject to tax on more than the income actually received by them as a unit.[124]

From a tax standpoint, therefore, a transfer of property, from which periodic alimony payments will be made, is generally undesirable. The wife must include such payments in her taxable income, even though they may be paid out of capital, while the husband is allowed merely to exclude such payments from his income. In the illustrative case, therefore, it would not be desirable, taxwise, for the husband to purchase an annuity for his wife in satisfaction of his obligation to pay her monthly alimony. The matter might be handled by paying the proposed $90,000 directly to the wife and by her voluntarily purchasing an annuity with that sum. In such case, she would receive the monthly payments, and under Section 72 the amounts includible in her gross income each year would depend upon her own life expectancy at the annuity starting date. This arrangement would thus be of more benefit to the wife and, on the other hand, would not impose a tax detriment on the husband, since, in neither case, would any of the payments be included in his gross income nor would they be deductible therefrom. The husband might also consider the possible alternative of purchasing an annuity payable to him at the rate of $300 per month.

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[122] Section 72(k) of the 1954 Code expressly provides that Section 72, relating to taxation of annuities, "shall not apply to so much of any payment under an annuity, endowment, or life insurance contract (or any interest therein) as is includible in the gross income of the wife under section 71 or section 682. . . ." Cf. Section 22(b)(2) of the 1939 Code.

[123] See T.D. 6118, Prentice-Hall Federal Taxes (IRC Vol.) par. 23,103, outlining the procedure to be followed in computing the excludable portion of annuity payments under Section 72 of the 1954 Code. In the illustrative case, the "exclusion ratio" under Section 72(b) would be approximately 84 per cent, being $90,000 (the "investment in the contract" as of the annuity starting date) divided by $106,560 (the "expected return under the contract" as of the same date, which is the product of the $3,600 annual payments times 29.6, the husband's remaining life expectancy according to Table I of T.D. 6118, above). The annual exclusion under Section 72(b) is 84 per cent of the payments received, or $3,024. Only the remaining $576 is therefore taxable.

[124] See Gornick, *op. cit.*, footnote 3, above, page 44; Rudick, *op. cit.*, footnote 3, above, page 152.

In any event it would appear advisable, in cases of this nature, to provide that the support or alimony payments to be made to the wife be limited to payments from income of the transferred property, which would otherwise be taxable to the husband. If an additional amount over such payment is required to be made to the wife, the husband should pay it directly, rather than from the property transferred, in order that he may claim a deduction for the additional payment under Section 215 of the 1954 Code.

The foregoing results, with respect to periodic payments under a transferred annuity contract, apply also to periodic payments under life insurance or endowment contracts. The problem, with respect to such contracts, however, is more difficult and the tax results more uncertain. If, in order to meet an alimony obligation of $300 per month, the husband purchases or assigns, for the benefit of his wife, an annuity contract paying such an amount, the full $300 a month received by the wife, as we have seen, is includible in her income, and no part of such amount is deductible from the husband's taxable income. The tax effects are not so clear, however, with respect to proceeds received from life insurance contracts.

Section 101(a)(1) of the 1954 Code continues the general rule under Section 22(b)(1), excluding from gross income amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured. However, Section 101(e) expressly provides that "This section shall not apply to so much of any payment as is includible in the gross income of the wife under section 71 . . . or section 682 . . ." The provision is not explained in the Congressional committee reports, but apparently is derived from regulations issued under Section 22(b)(1) of the 1939 Code, stating that such insurance proceeds are exempt from income taxation except "in the case of a spouse to whom such payments are income under Section 22(k)."[125] No examples, however, are contained in the regulations as to when "such payments are income under section 22(k)." If such proceeds are paid in a lump sum, it would seem that the amount should not be taxable as income to the wife because it could not be considered a "periodic payment."[126] If such sum is payable in installments covering a period of more than ten years, however, such payments would appear to be taxable to the wife as "periodic payments" within the meaning of Section 71.

On the other hand, it is arguable that such a result should not follow in a case (1) in which the husband has irrevocably transferred a paid-up life insurance policy to the wife, which she may dispose of as she sees fit, or (2) where there has been no formal assignment of the policy to the wife, but she has been named irrevocable beneficiary of the policy.

In the former case, there has been a complete transfer of the policy to the wife and she is free to cash it in or dispose of it at her discretion. Thus, it is arguable that the transfer of the policy should be treated the same as a transfer of securities or other property.[127] Viewed in this light, any appreciation of value in the policy at the time of the transfer, over its cost to the husband, would be taxable to him,[128] and the wife, when she receives the proceeds, would be subjected to income taxation to the extent provided under Section 101(a)(2),[129] or Section 72(e).

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[125] Reg. 118, § 39.22(b)(1)-1.

[126] However, it might be contended that 10 per cent of such lump sum is taxable as an "installment payment" which "may be or is to be paid within a period ending more than 10 years from the date of such decree or instrument" within the meaning of Section 22(k) (now 1954 IRC § 71(c)(2)).

The same consequences should follow from the second situation, since the naming of the wife as irrevocable beneficiary may be treated as, in effect, an absolute assignment to her.

The confused and uncertain tax effects of alimony payments stemming from life insurance contracts make it clear that such arrangements should be avoided if at all possible.[130] In many cases it might be possible to substitute alternative methods, in order to achieve the results desired by the parties. For example, if the wife desires to have insurance on the husband's life, it might be possible to increase the periodic payments to her so that she may take out her own policy. This alternative, of course, is not open if the husband is uninsurable. In such event, consideration might be given to the possibility of the creation of a trust of which the wife would be the life income beneficiary only of the proceeds after her husband's death.

4. Alimony Payments Attributable to Property Transferred in Trust

There are two 1954 Code provisions applicable to the taxation of alimony trusts, Sections 71 and 682. These sections correspond to Sections 22(k) and 171 of the 1939 Code. It has been pointed out above that Sections 71(a)(1) and (2) apply to alimony and support payments attributable to property transferred in trust or otherwise in discharge of the obligation to support made specific in a decree or instrument incident to divorce, or under a written separation agreement. Thus, Section 71 does not apply in the case of trusts that are not provided for in the decree, in a written instrument incident to divorce, or under a written separation agreement. In order to cover such situations and to provide uniformity of treatment with respect to the taxability of income from alimony trusts, Section 71 is supplemented by Section 682. Section 682 provides, broadly, that there shall be included in the gross income of the divorced wife, and not the husband, "the amount of the income" of any trust that she is entitled to receive and that, except for the provisions of Section 682, would have been taxable to the husband regardless of any other income tax provision of the Code. As a result, therefore, the income from any alimony trust payable to the wife is now taxable to her and is excludible from the gross income of the husband.

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[127] See Rudick, *op. cit.*, footnote 3, above, at pages 153-154.

[128] *Commissioner* v. *Mesta* (3 Cir. 1941), 123 F. 2d 986, 28 AFTR 441, cert. den. 316 U.S. 695 (1942). It would seem that no gain would ordinarily result under this view since the value of the policy would normally probably be less than its cost measured by the total premiums paid. However, probably no deductible loss would be allowed if this were true because of Section 267 of the Code, which disallows losses from sales or exchanges between members of a family, if the wife is still a member of the family, for this purpose, at the time of the transfer.

[129] As a transferee for a valuable consideration. Cf. Reg. 118, § 39.22(b)(2)-3. See *Alcy S. Hacker*, 36 B.T.A. 659 (1937).

[130] See Gornick, *op. cit.*, footnote 3, above, especially note 74 in which it is stated: "Alimony settlements involving life insurance and annuity contracts open up many new problems and give promise of being the most fruitful source of litigation under the amendments. If a husband transfers a life insurance policy to his divorced wife, is the value of the policy to be treated as a lump-sum settlement or as a gift? Or is the transfer in the nature of a sale or exchange for a valuable consideration? If there is an irrevocable 'gift' of a policy, and the husband thereafter pays the premiums, each premium payment may be a taxable gift. U.S. Treasury Reg. 79, Art. 2. Ordinarily where a life insurance policy has been transferred for a valuable consideration, payments on account of the death of the insured constitute income to the assignee to the extent that they exceed the sum of the consideration paid by the assignee and the premiums and other amounts subsequently paid thereon by such assignee. IRC § 22(b)(2). Does this rule apply in case a policy providing for a single payment on death is transferred to a wife as part of the alimony settlement? See *Commissioner* v. *Mesta*, 123 F. 2d 986, 28 AFTR 441 (3 Cir. 1941), cert. den. 316 U.S. 655, 62 Sup. Ct. 1290 (1942). Are the full proceeds of such a policy taxable if the insurance proceeds are payable in more than ten yearly installments? Will an outright transfer of a policy result in the realization of a gain by the husband? See *Commissioner* v. *Mesta*, above. These and other questions involving settlements of this nature will in all probability be involved in litigation."

As in the case of Section 71, Section 682 is applicable only where the parties are divorced or legally separated under a decree of divorce or of separate maintenance, or where they are separated and there is a written separation agreement. Thus, Section 682 does not apply where the parties are separated, although not under a separation agreement. However, there are important differences between Sections 71 and 682. As already mentioned, Section 682, unlike Section 71(a)(1), does not require that the alimony obligation being discharged be imposed upon the husband pursuant to a decree or a written instrument incident to divorce. As previously mentioned, Section 71 requires, also, that all periodic payments attributable to property transferred in trust be includible in the wife's income, irrespective of whether such payments are from income or corpus. Under Section 682, such payments are taxable to the wife only to the extent that they are paid out of income of the trust.

It is immaterial, so far as the trustee is concerned, whether the trust is covered by Section 71 or by Section 682. In either case, the wife is considered the beneficiary of the trust and is required to report her income in the same way as the beneficiary of any other trust.

The following is an example of a trust covered by Section 682:

Shortly after their marriage H transfers property in trust to pay the income to W for her support and maintenance. Some years later the wife obtains a divorce. Under the laws of the state, the husband has a continuing obligation to support the wife. Although the Court had jurisdiction under the law of the state to make provision for alimony, no mention is made of it in the divorce decree, because W is relying upon the income from the trust to support her. There is no separation agreement. Section 71 therefore is not applicable. Because of Section 682, however, the income of the trust payable to W after the decree is includible in her income and is deductible by the trust. No part thereof is includible in the husband's income or deductible by him.[131]

It is clear, therefore, that if the husband, in the illustrative case, creates a trust to defray part of his alimony obligation, the income from the trust would be taxable to the wife. No part of such income, of course, would be taxable to the husband, nor deductible by him from his other income.

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[131] Were Section 682 (1939 IRC § 171) not in effect, the husband would naturally be taxable on the income because of his continuing obligation under state law. *Helvering* v. *Fitch*, 309 U.S. 149 (1940), 24 AFTR 1032; *Helvering* v. *Fuller*, footnote 2, above. The law for the period prior to the enactment in 1942 of the 1939 Code provisions, is summarized in Gornick, *op. cit.*, footnote 3, above, at pages 29-36.

5. Conclusion

The new provisions of the 1954 Code, relating to the taxation of support, alimony and separate maintenance payments, have opened new areas for tax planning. The extent to which these provisions will permit greater flexibility in arrangements between separated and divorced parties will, of course, depend upon how broadly they are construed particularly by Regulations under the new Code. Accordingly, it would seem highly desirable, in any case involving settlement agreements between spouses, to include appropriate provisions for readjustment of the payments, in the event that it should ultimately be established that such payments for tax purposes should be treated differently from the method contemplated by the parties at the time the payments were agreed upon.

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81

How to Operate Family Transactions Other Than Partnerships and Trusts

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Transactions among members of the family present a ready means for tax planning. The main objective of family tax transactions is to utilize fully exemptions and deductions and to arrange the respective incomes so that the combined Federal tax will be at a minimum.

The "marital deduction,"[1] removed generally the necessity and incentive for husband-wife tax transactions. However, in some cases a joint return may not be possible because of differences in taxable years, non-resident alien status, or separation. Moreover, a joint return may not be desirable because of income and deduction peculiarities,[2] and there are other tax consequences of husband-wife tax relations that remain of consequence in tax planning. Finally, opportunities for tax savings still exist with respect to arrangements with other members of the family.

In general, family transactions refer to those between husband and wife or parent and children. The purpose of this chapter is to discuss only tax arrangements between persons of the above relationships. The discussion will generally be in terms of husband-wife, but except where otherwise noted, the same rules apply with respect to parent-child transactions.[3]

1. Points to Consider

Here are the main points you would wish to consider with your client in order to arrange his affairs most advantageously taxwise:

Section

What will be the effect of family tax transactions on family nontax relations? 2
Tax transactions that are available to the family, such as:
  How to operate family joint ventures 3
  How to operate family joint ownerships 4
  How to operate family gifts of income-producing property . . 5

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[1] 1954 IRC § 2.

[2] Some of these peculiarities are capital losses, net capital loss from a previous year and medical expenses paid by each spouse if each has income. *James H. Cunningham,* 20 T.C. No. 9 (1953). See also Tax Barometer Sec. 2. Feb. 28, 1953, pp. 3-4.

[3] Throughout this chapter reference to husband, wife and children, when by letter, will be as follows: Husband, "A"; wife, "B"; children, "C," "D," etc.

Section
How to operate family ownership of stock in closed companies 6
How to operate family sales of other property 7
How to operate family compensation agreements 8
How to operate family loan agreements 9
How to operate family rental agreements 10

2. Family Tax Transactions vs. Family Non-Tax Relations

Family tax transactions often have not only income tax consequences, but also estate and gift tax consequences. Every family tax transaction should therefore be considered in the light of the interrelationship of the various taxes. The income tax savings often arise from the differential in top rate between the husband-parent and the wife or child. The widest possibility is that taxable income may be moved from the parent, who is subject to a top rate of 91 per cent, to the child, who is subject to the minimum rate of 20 per cent. The maximum shift in tax rate on capital gains is from 25 per cent to 10 per cent. Against this income tax saving must be considered the fact that as a result of the shift in income the parent may lose a dependency exemption for a child and possibly certain deductions connected with the property transferred. These factors must be balanced in order to determine the net income tax savings. A gift tax may also be due on the transfer. This tax and its timing must be offset against the estate tax saving that is involved through the exclusion of the property involved from the estate of the parent when he dies. Different cases produce different results, and a final determination of the ultimate total tax savings in a transaction can be made only by computation. The generality that a shift of income-producing property from a parent to a child will produce a total net saving is not always true. Only by determination of the result in each particular case can the value of a proposed transaction be appraised.

Because of the tax-saving possibilities of family transactions and the close relationship of the participants, all family transactions are suspect and care must be exercised that scrutiny will reveal substance in the transaction and that it is what it purports to be. Do not, for example, go through the motions of making a gift of stock to a child but not arrange for the ownership to be transferred on the books of the corporation.

Finally, tax transactions have nontax implications. For example, a transfer of property from father to son may save the father income tax, but the son may not be capable of managing the property. What happens to the father's parental authority in the light of the son's newly found wealth? What effect will this transfer have on the parent's relationship with his other children?

To find the answers to these questions and others like them, you must decide the following:

1. Will a tax transaction designed to save income tax, have also desirable (or at least no undesirable) estate and gift-tax effects so that the net tax effect is favorable?
2. Will the transaction stand up as one having substance when scrutinized by the Internal Revenue Service and the courts?
3. Will a proposed tax transaction have nontax effects on his family that the taxpayer is ready and willing to accept?

Every proposed family tax transaction should be tested in the light of these questions. Only if the answer to each of these questions is YES should a family tax transaction be pursued.

3. How to Operate Family Joint Ventures

Joint ventures may be considered as an alternative to a family partnership.

A characteristic of a joint venture is that it is usually not an investment but a business enterprise of limited duration and involves a transaction in which capital rather than services are of primary importance.

Although the revenue laws speak of joint ventures together with partnerships, the stringent conditions existing with respect to a family partnership do not yet exist with respect to family joint ventures.[4]

Thus, for example, the taxpayer was successful in a case where a mother loaned her son money for a new business and received a demand note without interest and an agreement to receive 50 per cent of the venture's profits.[5]

Caution should be exercised that the venture is in fact joint in nature. Thus, income from a joint venture ostensibly by a group of wives, was nevertheless taxed to the husbands where it was shown that only the husbands' skills and activities produced the income, where the wives did nothing but sign necessary papers and where the capital contributions of the wives were of no importance in producing the income.[6]

Caution should also be exercised so that, in attempting to form a family joint venture, you are not caught in the dilemma of having the venture treated as a partnership or as a corporation. If it is held to be the former, it may not be recognized for tax purposes if it does not meet the family partnership rules; if it is held to be the latter, it will be taxed as a corporation.[7]

The main characteristics of a joint venture that distinguish it from a partnership or corporation are not entirely clear. Cases on the subject appear to highlight the following:

1. The venture is of limited duration.[8]
2. Owners, regardless of the varying nature of their rights, agree on a plan for the joint development and operation. They designate a common agent, a division of expense, and a method of dividing the proceeds in accordance with their respective interests.[9]

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[4] See *Tuthill,* 22 B.T.A. 887 (1931); *Godson,* 5 T.C.M. 648 (1945). 46,182 Prentice-Hall Memo T.C. See also *U.S.* v. *Atkins* (5 Cir. 1951), 191 F. (2d) 951; *Klein* 18 T.C. No. 98 (1952); *Cray,* 11 T.C.M. 1051 (1952).

[5] J. K. Lasser, *Business Tax Guide,* p. 80. New York: Simon and Schuster, Inc., 1948.

[6] Murphy, F. L. "What is the Recent Status of the Family Partnership," *Proceedings of New York University Eighth Annual Institute on Federal Taxation* page 1070; Gemmill, K. et al, "Outline of Revenue Act of 1951" *Proceedings of New York University Tenth Annual Institute on Taxation,* pages 957, 959; *Leonard,* T.C. Memo No. 26966 (1953); See *Mauritz* v. *Schofield* (D.C. Tex., April 28, 1952) where income was divided among 29 relatives and family trusts.

[7] Brabson, "What Constitutes an Association Taxable as a Corporation," *Proceedings of New York University Seventh Annual Institute on Federal Taxation,* p. 1282. New York: Matthew Bender and Company, 1949.

[8] *DuPont,* 37 B.T.A. 1198 (1938).

[9] Brabson, *op. cit.,* footnote 7, above.

3. The taxpayer becomes a tenant in common with others to develop the property for their general benefit. He has a contract with another to operate the property and charges the several tenants with their share of the expenses.[10]

"Do's and *Don'ts"* in joint ventures.

Do	*Don't*
Consider use of a joint venture as an alternative to a family partnership, especially where a transaction of limited duration is involved and the taxpayer wishes to split income from a single source with a family member.	Overlook the distinctions drawn between a joint venture on the one hand and a partnership or corporation on the other.

4. How to Operate Family Joint Ownerships

Joint ownership may be of three kinds: tenancy by the entirety, joint tenancy, and tenancy in common.

Tenancy by the entirety. A tenancy by the entirety is an arrangement available only between husband and wife. Where the common law concept of a tenancy by the entirety exists, the income from such property is taxable only to the husband and such tenancies offer little tax attractiveness. This is true, for example, in Massachusetts. Other states hold an estate by the entirety to be equivalent to a joint tenancy. (See the discussion of joint tenancy that follows.)

Regardless of state law, however, gains and losses from the sale or exchange of property held by husband and wife as tenants by the entirety, must be divided between them and thus reported by them.[11]

Further, Courts have looked to the motive for creating an estate by the entirety. One case held [12] that the husband remained taxable on all the income of an ostensible tenancy by the entirety because, from the facts, it appeared that the tenancy was not a bona fide arrangement for the conduct of business but only a means of shifting family income.

Joint tenancy. A joint tenancy is available to any related or nonrelated taxpayers and is the most common form of joint ownership. Except for the items noted above, joint tenancies and tenancies by the entirety are subject to much the same rules and the following discussion applies equally to both although reference is made to joint tenancies only.

In a joint tenancy, each tenant reports his own half of the net income.[13] However, where one tenant pays *all* the interest or taxes, he is entitled to deduct all such payments.[14] On the other hand, even though one tenant in fact keeps all of the net income, he is taxable on only one-half and the other tenant, although he really receives nothing,[15] is also taxable on one-half. Thus, it is possible for one taxpayer to claim all the deductions for taxes and interest but to be taxable on only one-half the income. In parent-child joint tenancies this fact should be considered since the deductions are of much more value to the high-income parent than to the low-income child.

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[10] *Commissioner* v. *Happold* (5 Cir. 1944), 141 F. 2d 199 32 AFTR 271.

[11] I.T. 1574 II-1 C.B. 1943. See also Harry Rudick, "Federal Tax Problems Relating to Property Owned in Joint Tenancy and Tenancy by the Entirety," 4 *Tax Law Review* 3 (1948).

[12] *Godson,* 5 T.C.M. 648 (1945) 46,182 Prentice-Hall Memo T.C.

[13] *Haynes,* 7 B.T.A. 465 (1928), I.T. 3754, I.R.B. 1945-16-12109.

[14] I.T. 3785, 1946-1 C.B. 98.

[15] *Tracy* v. *Commissioner* (6 Cir. 1934), 70 F. 2d 93 13 AFTR 928 reversing 25 B.T.A. 1055 (1932); *Greene* 7 T.C. 142 (1946).

A joint tenancy, which under the Internal Revenue Code is not subject to different rules from a partnership, is nevertheless not subject to the strict construction applicable to family partnerships. This distinction is probably true because the question has not been tried as often as family partnerships. Thus, in some cases where it was held that a partnership did not exist, a division of income was nevertheless allowed on the grounds that some sort of joint ownership existed.[16] Where a tenancy by the entirety was involved, the income was held divisible, even though the capital originated with the husband and the wife rendered no substantial services. Where a joint tenancy was involved, the courts have come to more labored conclusions, allowing a division of income, but sometimes, as in the *German* case, only on the basis of the relative values of the services performed.

When, instead of being under ownership in joint tenancy, property is held under a joint account or was purchased from a joint account, income from the property is taxable to each owner according to his ratable contribution to the joint account regardless of title.[17]

Losses resulting from purchases and sales directly or indirectly between closely related persons are not allowed.[18] Thus, in one case, a taxpayer sold stock at a loss and deposited the proceeds in a joint account. Because his wife immediately thereafter purchased the same securities by drawing a check on the joint account, the loss was disallowed on the grounds that the taxpayer was in effect dealing with himself.[19] Similarly, no deduction is allowable if the wife merely goes through the form of payment but the funds are not hers. Thus, no loss is recognized if the wife's purchase is charged against a bank account opened for her for that purpose by the husband[20] or if the taxpayer guarantees his wife's broker's account.[21]

Managerial control is not a test of a valid joint ownership. Thus a husband or parent may retain control over the property held in a joint tenancy without necessarily being subject to tax on all the income from such property.[22]

The basis of the interest in property received by a surviving joint tenant or tenant by the entirety with respect to a decedent dying after Dec. 31, 1953 is the value of the property for estate tax purposes (Sec. 1014 IRC of 1954). Under prior law, the fact that one-half or even all the property may have been included in the gross estate of the deceased tenant did not give the surviving tenant a stepped-up basis. The grounds for this rule was that the surviving tenant did not take by "bequest, devise, or inheritance" as required by Sec. 113(a)(5) IRC of 1939, but rather that his title has been in the entire property from the outset, subject only to the interest of the other tenant, who is now deceased.

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[16] *Webster*, 4 T.C. 1169 (1944); *German* 2 T.C. 474 (1943); *Greene*, footnote 15 above; *Sandery*, 8 T.C. 423 (1947).

[17] *First National Bank of Duluth, Special Administrator*, 13 B.T.A. 1096 (1928), *Bekins*, 20 B.T.A. 809, (1931). *Dunham*, 27 B.T.A. 1068 (1933), *Gilette*, 18 B.T.A. 434 (1929); *Meier*, T.C. Memo. op. Dec. 3008 (1951) C.C.H. 18,666, aff'd (8 Cir. 1952), 199 F (2d) 392.

[18] 1954 IRC §§ 267, 1091; Eifler, R. K. "Restrictions on Transfers Between Members of a Family." *The American University Tax Institute Lectures*, Vol. 4 pp. 171-202 (1952).

[19] *Niles v. Melbourne* (6 Cir. 1939), 100 F. 2d 723, 22 AFTR 177.

[20] *Blumenthal*, 30 B.T.A. 125 (1934).

[21] *Brochon*, 30 B.T.A. 404 (1934); *Gunney*, 26 B.T.A. 894 (1932).

[22] *Tracy, supra*, see footnote 15; cf. *Cohen*, T.C. Memo op. Dec. 13, 427 (M) 43,401 Prentice-Hall Memo T.C.

In the case of a tenancy created by gift, when a loss is involved, the basis is determined as a gift of the interest and the basis is the original cost or value of the property at the date of creation of the tenancy, whichever is lower.[23]

Tenancy in common. Under Internal Revenue Code of 1939, a tenancy in common offered many of the tax advantages of other joint ownership arrangements and fewer of the tax disadvantages.

A loss on a sale of property to relatives may be recognized if sold to them as tenants in common although not recognized if sold to them as joint tenants or tenants by the entirety. Thus, if property is sold at a loss by a father to his daughter and her husband as joint tenants, the loss is disallowed since the daughter has an undivided interest in the whole property and she is in the class of relatives among whom losses are not recognized (Sec. 267, IRC of 1954). If, however, it is sold as a tenancy in common, then the son-in-law receives a separate half interest. Since a son-in-law is not included under Sec. 267, IRC of 1954, the loss attributable to that half is recognized.

Since an interest in a tenancy in common may be willed, it was held under prior law that the surviving tenant received that interest by "bequest, devise, or inheritance" as required by Sec. 113(a)(5), IRC of 1939, with the result that he received a stepped-up basis for that part of the property. The Internal Revenue Code of 1954, however, eliminated this distinction and with it this tax advantage of a tenancy in common over other forms of joint ownerships.

"Do's" and *"Don'ts"* on joint ownership.

Do	*Don't*
Consider individual factors of case before embarking on any type of joint-ownership, i.e., life expectancies, relative tax brackets, relative estates, prospective value of property.	Enter into a joint ownership arrangement through a gift if the value of the property is subject to substantial fluctuations.
Consider joint ownership arrangement where a family partnership would not be recognized because of no separate capital contribution or services rendered by the wife or child.	Enter into a joint ownership arrangement in order to minimize tax on a transaction that is virtually concluded before the creation of the tenancy.[24]
Consider joint ownership where managerial control is of importance, i.e. parent and child may own property and divide income as joint tenant although the parent retains full managerial control.	

5. How to Operate Family Gifts of Income Producing Property

Gifts of income producing property offer a ready means for the splitting of income among members of a family. The one basic requirement is that the gift

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[23] 1954 IRC § 1015.

[24] I.T. 3754, 1945, C.B. 143; See also *Birren & Son, Inc.*, v. *Commissioner* (7 Cir. 1940), 116 F. 2d 718 26 AFTR 197. *McInerney* v. *Commissioner* (6 Cir. 1936), 82 F. 2d 665, 17 AFTR 683.

must be the property producing the income and not merely the income itself.

The basic decision in the nonrecognition of assignments or gifts of income only is *Lucas* v. *Earl*[25] where an attorney attempted to create a joint tenancy of his fees with his wife. Mr. Justice Holmes, who held for the Supreme Court that such an arrangement could not be recognized, stated in effect that the fruit could not be attributed to a different tree from that on which it grew. This same philosophy runs through the rules on assignment of partnership earnings,[26] interest coupons,[27] renewal commissions,[28] and royalties.[29]

Profits from the sale of property that was transferred to members of the family shortly before the sale are taxable to the donees, even though tentative negotiations were held between the donor and the prospective purchaser before the property was transferred. However, the gift must be absolute and bona fide. Intention to reduce tax will not affect the bona fides of the transaction.[30]

A wife may use income from a partnership interest, which she has received as a gift and the income of which is wholly taxable to her husband, to purchase property. The income from this property is taxable to the wife. Thus, even though no tax savings may be involved in a husband-wife partnership, a gift of an interest in a business may be advantageous as a means of dividing the reinvested income from the partnershp.[31]

Examples of types of assignments and gifts and their tax effects are as follows:[32]

	Income Taxed to	
Assignment or Gift of	*Assignor*	*Assignee*
Earnings first acquired by husband or wife and then assigned	x	
Income producing property, if assignment is complete and no strings are retained		x
Portion of profits paid in consideration for a bona fide loan, even though the amount loaned was received earlier as a gift from the assignor		x
Partnership profits by a partner	x	
Amounts due to be paid under a contract for the sale of stock	x	
Income-producing contract that involves no services by assignor		x
Property that is sold at a profit soon after the assignment, if the property was delivered absolutely to the assignee before the sale[33]		x

Gifts of property to children are particularly attractive in cases where extraordinary income is expected. Thus, if a parent expects a large dividend, or an oil strike, a gift of the stock prior to the date of the dividend or the oil strike will shift the taxability of the income to the child. Property held by a dealer may be assigned to a member of the dealer's family who is not a dealer. Sale by the assignor would here result in ordinary income; sale by the assignee would result in capital gain. Even where the assignor is not a dealer, a saving may result if a sale of property at a gain is involved. Giving the property to a child prior to the sale may reduce the rate of tax on the capital gain from 25 per cent to 10 per cent (the lowest bracket rate, 20 per cent on one-half of the gain).[34]

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[25] 281 U.S. 111 (1930).

[26] *Burnet* v. *Leininger*, 285 U.S. 136 (1932) 10 AFTR 1601.

[27] *Helvering* v. *Horst*, 311 U.S. 112 (1940) 24 AFTR 1058.

[28] *Helvering* v. *Eubank*, 311 U.S. 122 (1940) 24 AFTR 1063.

[29] *Commissioner* v. *Sunnen*, 333 U.S. 591; *Strauss* v. *Commissioner* (2 Cir. 1948), 168 F. 2d 441 36 AFTR 611.

[30] *Lawton, et al.* v. *Commissioner* (6 Cir. 1947), 164 F. 2d 380 36 AFTR 386.

[31] *Schreiber*, 6 T.C. 707.

[32] J. K. Lasser, *Business Tax Guide*, p. 83. New York: Simon and Schuster, Inc., 1948.

[33] But see I.T. 3910, 1948-13-12836; I.T. 3932, 1948-26-12994.

Even where no extraordinary income is involved, a gift of income producing property to a child is desirable. Income from gifts are taxed to the child, not the parent. If gross income is less than $600 per year, the income is wholly tax-free and in addition, the parents still get a $600 dependency credit for such child. The parents may still get the dependency credit regardless of the amount of income the child has if such child is under 19 or if 19 or older is a student, provided the taxpayer provides more than one-half of the child's support (Secs. 151, 152 IRC of 1954). Managerial control by the parent will not vitiate an otherwise good gift provided such control is for the benefit of the donee.[35] Where the evidence shows the management is not primarily for the benefit of the donee, the income will be taxed to the donor.[36]

Gifts to minors sometimes create problems. It may be charged that such a gift is not complete, or if in trust may be attacked as a gift of a future interest. (See Sec. 2503(b) IRC of 1954.) One way to insure protection against such attack is to make the gift in trust but subject to a provision which permits the infant or his guardian to terminate the trust at any time by making demand on the trustee.[37]

A unique opportunity exists particularly for excess profits tax in the case of personal service corporations. If a gift of stock in such a company is made to a child before the end of the corporation's taxable year, such child is deemed to receive his share of the undistributed profits of such corporation.[38]

"*Do's*" and "*Don'ts*" on gifts of income producing property.

Do	*Don't*
Make gifts to members of the family as a method of splitting income.	Make gifts of income such as future earnings, interest coupons, commissions, dividends, etc.
Make sure gifts are income producing property and not income only.	Retain strings on ownership.
Make gifts in proper form. (The donor and donee must be competent; there must be a clear intention to make the gift with irrevocable transfer, good delivery, and acceptance by the donee.)	
Consider making a gift prior to sale of property.	

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[34] J. K. Lasser, *Report on Taxes*, Aug. 15, 1951.

[35] *McQuown*, T.C. Memo No. 35310 (1953); *Louis Visintainer* 13 T.C. 805 reversed (10 Cir. 1951), 187 F. 2d 519, Cert. den. 342 U.S. 859; *Robert Alexander*, et al., 9 T.C. M 115, reversed (5 Cir. 1951), 190 F. 2d 753; cf. *Phillips* v. *U.S.*, D.C., Texas 51 U.S.T.C. 9190 Aff'd. (5 Cir. 1951), 193 F. 2d 132; *Denmark* T.C. Memo 5/24/54.

[36] *Royce*, 18 T.C. No. 92 (1952); *Pleason*, 22 T.C. No. 48 (1954).

[37] *Kieckheffer*, 15 T.C. 11 reversed (7 Cir. 1951) 189 F. (2d) 118; cf. *Arthur C. Stifel, Jr.*, 17 T.C. 647 aff'd. (2d Cir. 1952) 197 F. (2d) 107; *J. K. Lasser Reports*, June 15, 1951; Shattuck, M.A. "A Practical Consideration of Some of the Legal and Tax Problems Inherent on Gifts to Minors," Nov. 1951 Vol. 31 *Boston U. Law Review* page 451. See also 1954 IRC § 2503(c).

[38] *J. K. Lasser Report on Taxes*, Dec. 15, 1951.

6. How to Operate Family Ownership of Stock

Stock ownership by members of a family offers the readiest means of dividing income without surrendering control. Such ownership yields not only income tax but also estate tax savings.

If your client is the owner of substantially all of the stock of a corporation or is considering the formation of a wholly new corporation, a desirable procedure from the family tax standpoint is for him to arrange to receive two classes of stock: (1) common stock, and (2) nonvoting preferred stock. The nonvoting preferred may then be given or sold to his wife and children. The net effect of this transaction is that the wife and children will receive and be taxed on the dividends declared on the preferred stock, but the husband-parent will control the corporation through his voting common stock and also, to a degree at least, the amount and timing of the dividends payable on the preferred stock.

A gift tax is involved in the transfer of the stock and a valuation problem exists, but this is neither essentially different nor greater than the problems inherent in the valuation of stock in a closely held corporation.

Consideration might also be given to sales of stock among members of a family. Thus, if a parent needs cash and the son has cash, which may or may not have been received as a gift from the parent, the parent may sell the stock to the son. If the stock is sold at fair market value, no question is involved. The father has a gain; the son has his cost as a basis for the stock; and the entire deal is as if it had been made between strangers, except that (1) control of the stock remains in the family and (2) income is shifted from the father to the son.[39]

If the stock is sold at cost so that no gain is realized by the father, a gift to the extent of the difference between the sales price and the fair market value is made.[40] If the stock is sold at a loss, such loss would be disallowed under specific provisions of the Internal Revenue Code.[41] However, the benefits of such a transaction are not entirely lost. If the relative who purchased the property subsequently sells it at more than his basis, his gain is recognized only to the extent that it exceeds the amount of the disallowed loss. If, however, the loss arises as a result of sales between relatives other than those specified in the Code, such as an uncle, cousin, or "in-laws," the loss is allowable. Thus, if the taxpayer realized a loss on sale of stock in a family corporation to his sons-in-law, the loss is allowed, even though the sons-in-law received the funds from their wives, who in turn had received the funds as gifts from the taxpayer.[42] It should be noted that where property is sold at a loss, it may be advantageous to sell the property to one who is not one specified under

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[39] *Rosborough,* 8 T.C. 136.

[40] *Fincke,* 39 B.T.A. 510, appeal to C.C.A.-2 dismissed Sept. 22, 1939; I.T. 3335 1939-2 C.B. 193.

[41] 1954 IRC § 267. The family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. Included however, also are certain fiduciary arrangements and charitable organizations (See Sec. 267(b)). These rules apply only with respect to taxable years ending after Dec. 31, 1953. For rules under prior law see 1939 IRC § 24(b)(1)(A). This section does not apply to losses under "wash sales" (1954 IRC § 1091, 1939 IRC § 118).

[42] *Saul,* 6 T.C.M. 734 (1946) Dec. 15, 884(M), cf. *Nordling* v. *Commissioner* (9 Cir. 1948), 166 F. 2d 703 cert. den'd. Oct. 11, 1948 36 AFTR 837. For effect on basis of stock bequest to family corporation see *A. J. Diebold* (3 Cir. 1952), 194 F. (2d) 266.

Sec. 267 at a lesser price and get the benefit of the loss than it is to sell it at a higher price to a close relative and lose the benefit of the loss.

Unless the transaction is a bona fide one, it may be set aside even though the sale by the husband-parent is at a gain.[43] For example, suppose a husband has capital losses against which he has nothing to offset. If he sold some of his stock to his wife at a gain, the stock would have a jacked-up basis in the wife's hands at no tax cost to him. Thus if "A" has a cost basis of $200 for stock, a $100 capital loss, and sells stock to his wife for $300, the capital gain offsets the capital loss and the stock has a basis of $300. However, unless it is shown that the sale was bona fide and in good faith, the increased basis may not be allowed.[44]

The husband-parent should keep no strings attached to the ownership of property that he has transferred. Thus, restrictions on sale or transfer of the stock, failure to record the stock on the company stock record books, or failure to comply with other formalities of transfer of the stock may cause investigation of the purported transfer.[45]

Family corporations may be used not only for separating oneself from income tax liability but also for controlling the amount and nature of individual income received. Thus, taxpayer organized two corporations for the construction and real estate business and engaged in those businesses. Subsequently he sold to these companies in exchange for notes, certain oil properties. He reported a capital gain on the sale. The Treasury attempted to set aside the transaction and tax the oil royalties to the taxpayer. The taxpayer was upheld because (1) the corporations were real, (2) the transactions were real (3) there was a business purpose—i.e., working capital need.[46]

The other side of the possibility is where taxpayer and wife owned a corporation with two franchises. The taxpayer caused the cancellation of one franchise and its subsequent reissue to him individually. The Treasury attempted to tax all of the income to the corporation. The taxpayer was upheld on the grounds of being able to choose his form of business.[47]

Important possibilities exist not only in having stock owned by family members but also in dividing up corporations by spin-offs or other reorganization methods so that the taxpayer may have flexibility as to which assets shall be under his control and which shall be under the control of members of his family.[48]

"*Do's*" and "*Don'ts*" in intrafamily stock ownership.

Do	*Don't*
Consider having stock owned by relatives.	Sell stock to family members at a loss except in the light of the provisions of Sec. 267 IRC of 1954.
Consider having relatives own only nonvoting stock.	Retain strings on ownership.
Consider sales to relatives other than those specified in Sec. 267 I.R.C. of 1954.	

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[43] *Fitzgibbon,* 19 T.C. No. 14 (1952); cf. *Goldman,* 6 T.C. M 657, aff'd (4 Cir. 1948) 165 F. (2d) 686.

[44] Research Institute of America, *Analysis 62 Family Transactions,* p. 8.

[45] *Gouldman* v. *Commissioner* (4 Cir. 1948), 165 F. 2d 686 36 AFTR 689.

[46] *Spencer,* 19 T.C. No. 89 (1953).

[47] *Rolland Motor Co., Inc.* T. C. Memo No. 30189 (1953).

[48] See Chap. 5 for methods of dividing a business into several parts.

7. How to Operate Family Sales of Other Property

Sales of property other than stock in closed corporations are guided by much the same principles as sales of stock. Bona fide sales between members of a family at fair market value present no special problems. As noted previously, sales at less than fair market value entail a gift to the extent of the difference between the sales price over the fair market value, and sales at a loss entail disallowance of the loss to the seller. The general idea of sales of property other than stock is less attractive, however, than sales of stock because it may not be possible to exercise control over the property after it has been sold. The importance of continued control should be considered in planning tax savings through sales within the family.

One frequent feature of recent intrafamily property sales involves a sale together with a lease-back arrangement. Such an arrangement can be very advantageous taxwise if (1) the sale is bona fide and (2) the rent is reasonable.[49] Caution should be exercised to see that the sale is bona fide, that no strings are retained on the property, and that all the formalities of sale are followed.[50]

Consideration should also be given to the possibility of a sale of property in exchange for an annuity. Thus, when a parent wishes to retire, he may sell the property to his children in exchange for their promise to pay him an annuity. In such a case, the amount returnable by the parent as income each year under prior law was 3 per cent of the cost of a commercial annuity of a like amount.[51] (Under the Internal Revenue Code of 1954 different rules apply for taxable years beginning after 1953. See Secs. 72 and 7851(a)(1)(A) IRC of 1954.)

In the dissent in one case,[52] several factors were pointed out in arguing that no sale has been consummated in such a transaction. These factors were (a) stock was in a family corporation and retention of control was contemplated; (b) the value of the stock was greater than the amount needed to purchase the annuity and a gift tax on the excess was paid. These points indicated to the dissenting judge that all that was involved in the transaction was a transfer of property with a reservation of life income and a power to invade principal, if necessary, to the extent needed to pay the annuity.

In an earlier estate tax case, a similar line of reasoning was advanced by the majority of the court. In that case,[53] an estate tax was sustained on stock in a family corporation, which the decedent had sold to her children in consideration of a right to receive an annual salary from the corporation for life.

In order to raise as few questions as possible, therefore, an arrangement of this kind should—

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[49] *Skemp* v. *Commissioner* (7 Cir. 1948), 168 F. 2d 598, 36 AFTR 1089 rev'g. 8 T.C. 415 (1947); See also *Armston*, 12 T.C. No. 71 (1949); William L. Cary, "Tax Aspects of the Sale and Lease-Back of Corporate Property," *New York University Seventh Annual Institute on Federal Taxation*, p. 599. New York: Matthew Bender and Company, 1949.

[50] Button, R. W. "Some Problems of the Retailer: Real Estate Leases" *Proceedings of New York University Tenth Annual Institute in Federal Taxation* p. 259.

[51] *Estate of Bertha F. Kann, et al.* v. *Commissioner*, 6 T.C.M. 913 (1946); *Lloyd*, 33 B.T.A. 903; (1935) *Deering*, 40 B.T.A. 985 (1939); *Hommel*, 7 T.C. 992 (1946); *Raymond*, 40 B.T.A. 244 (1939), affirmed (7 Cir. 1940) 114 F. 2d 140, cert. den'd. 311 U.S. 710 (1940) 25 AFTR 583; *Gillespie*, 43 B.T.A. 399 (1941); *Sheridan*, 18 T.C. No. 44 (1952).

[52] *Estate of Bertha F. Kann, et al.* v. *Commissioner* (3 Cir. 1942), 130 F. 2d 797.

[53] *Estate of Pamelia D. Holland*, 47 B.T.A. 807 (1942), 1 T.C. 564 (1943).

1. Provide that the consideration, if for stock, come from the purchasers of the stock, not the corporation.
2. Provide that the annuity should be near in amount to that received from a commercial company for a like capital amount.

The use of such private annuities, even though it is recognized for tax purposes, is not without risk. Since the possibility of tax savings is dependent upon the annuitant's actual life span. If he outlives his expectancy, not only may the total value of the property transferred be restored to his estate, but in addition he may have paid each year some income tax on the annuity. It is clear, therefore, that in order for a net saving to result from this plan, the income tax paid each year, plus the estate tax on the value restored to the estate by the amount of annuity retained by the taxpayer, must total less than the estate tax would be if the transfer had never been made.

Notwithstanding this risk, in many cases, the private annuity represents the only means for obtaining an annuity without liquidating property and paying a capital gains tax. Thus if a 65-year-old man has a building with an adjusted basis of $20,000 and is now worth $100,000, he cannot use the property to purchase a $100,000 commercial annuity except by selling the property and paying the capital gains tax of $25,000. He would then have only $75,000 with which to buy an annuity. Through a private annuity he could transfer the property to his son in exchange for a $7,500 a year annuity, which is the annuity purchasable for $100,000 on a commercial basis. Through this transaction he has 33⅓ per cent more to use for his purchase and can thus receive a greater annuity. In addition, he has not realized any capital gain for tax purposes[54] and he has eliminated the gift and estate tax on the transfer because the transfer is for full and adequate consideration.

The effect of an annuity transaction on the transferee of the property has not been entirely settled as yet. One point that is clear, however, is that the transferee gets a stepped-up basis for the property even though he did not receive it by inheritance. The difference exists in what that basis shall be, the amount involved, assuming the annuitant lives out his expectancy, or the total amount that is actually paid out for the annuity. The first theory is not only the more desirable but the more practical because otherwise questions like bases for depreciation and sale are not determinable prior to the death of the annuitant. It is important that the taxpayer and his attorney keep this issue in mind when they draw the annuity.

Caution would suggest that a ruling be obtained from the Internal Revenue Service regarding the tax effects of any proposed annuity arrangement. Otherwise, the taxpayer may have to sustain his position in the courts, not only from the standpoint of the transferee but also with respect to such issues as contemplation of death and gift tax. The family annuity has many attractions, but discretion dictates caution lest the apparent attractions serve only to ensnare the taxpayer and his family.[55]

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[54] *Estate of Bertha F. Kann,* footnote 52 above.

[55] Harry T. Devine, "Intra-family Annuities," *Taxes,* 1948, Vol. 26, page 907, Casey, Wm. J. "How to use Intra-family Annuities." *Proceedings of New York University Eighth Annual Institute on Federal Taxation* page 1109; Meyer, M. E. "Transfer of Property for an Annuity—Tax Position of the Transferee," *Taxes* Aug. 1953 vol. 31 No. 8, page 645.

A taxpayer may try to avoid the disallowance of loss from a sale within his family by selling stock or other property on the open market and having his wife or child repurchase the same or similar property. Although the sale is made by the husband to an unknown person and the purchase by the wife or child is from an unknown person, the transaction will be considered an indirect sale between the related parties and the loss will be disallowed.[56]

This rule has thus far been asserted only where the transactions were almost simultaneous. Although it would seem that after a time lapse the loss from such a transaction should be allowable, no authority exists as to what that time period is.[57]

If it is desired to establish a loss, but still to maintain a position with respect to certain property, the surest procedure is for the stockholder to take the loss and then repurchase similar (but not identical) property himself. The effect will be a change in portfolio, but a complete disallowance of the loss involved will be avoided.

An interesting possibility for family ownership of property exists where, say, children buy a piece of property using funds acquired by gift or loan from the father and then rent the property to the father. If there is a bona fide lease and the rental is fair, the tax-saving potentialities of the transaction will not destroy its validity.[58]

Sometimes, however, agreements between husband and wife for sale of property do not accomplish their objectives. Thus, for example, husband and wife, as partners, attempted to create a buy-and-sell agreement, which among other things, provided that the survivor would not have to pay anything for goodwill. When the husband died, the Court found a goodwill value for the business and held that the agreement was not determinative because it was not at arm's length.[59]

The requirement for a bona fide transaction goes not only to the transfer itself, but to the terms of the transfer. Thus where a mother ostensibly sold property to children at a price below the market value in exchange for notes which bore less than the going rate of interest, the face value of the notes were discounted by the difference in interest rates, thus increasing the taxable gift involved.[60]

"Do's" and *"Don'ts"* in family sales of property other than stock.

Do	*Don't*
Consider the sale of property with a lease-back arrangement.	Attempt transactions that are sales in form but are not bona fide.
Consider the sale of property in exchange for annuity.	Sell to close relatives at a loss.
	Retain strings on property.
Consider having the taxpayer realize loss and repurchasing similar property rather than having a close relative repurchase identical property.	Attempt to avoid disallowance of loss by having a relative repurchase property the taxpayer sold on the open market.

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[56] *August Kohn, Jr., et ux.* v. *Commissioner* (4 Cir. 1946), 158 F. 2d 32, 35 AFTR 351.

[57] *Pauline Ickelheimer* v. *Commissioner* (2 Cir. 1943), 132 F. 2d 660, 30 AFTR 652. See especially Judge Hand's dissent.

[58] *Floridian Hotel Properties Inc.*, T.C. Memo C.C.H. 19,466 (1953); see also Sec. 10 of this chapter.

[59] *Trammell*, 18 T.C. No. 77 (1952).

[60] *Blackburn*, 20 T.C. No. 26 (1953).

8. How to Operate Family Compensation Agreements

Compensation paid to members of the family for services rendered to the husband-parent is deductible, if (1) the services are continuous, (2) the services are substantial, (3) the services are relevant to the operation of the business or the production of income, and (4) the compensation is reasonable. Compensation for slight services or those commonly rendered by wife or child are not deductible.

A partnership among nonrelatives may be a means of dividing income by employing relatives of the partners at a reasonable compensation for services rendered.

Specific statutory provision[61] requires that in the case of related taxpayers, as defined in the Code, expenses incurred, such as compensation, must be paid within the taxable year or within two and one-half months after the close thereof in order to be deductible. However, this provision does not apply if both the payer and payee use the same accounting method. Thus if the father-employer and son-employee both use the accrual method, the deduction is not lost even though payment is not made until after two and one-half months after the close of the taxable year, because the year of payment is also the year of receipt of the income.

Constructive payment, which involves also constructive receipt, has been interpreted to constitute payment.[62] Similarly, it has been held that payment by negotiable promissory notes constitutes legal payment even though the notes are not due until two and one-half months after the close of the payer's taxable year.[63] However, where there is no constructive receipt, there can be no constructive payment.[64]

Where a charitable foundation has been set up, employment by the foundation of relatives of the founder will not render the foundation taxable. Thus, if a parent sets up a foundation for charitable purposes, his son may be employed and paid for services rendered to the foundation.[65]

A parent may deduct reasonable wages paid to a minor child, even though under state law the child's wages belong to the parent. However, the parent may lose the right to such deduction to the extent that (1) the parent uses the child's earnings for himself, or (2) requires the child to purchase necessities, which the parent is legally obligated to supply to the child.[66]

Compensation paid to a son while in the armed services is deductible if (1) the son was in the business before entering the armed services and (2) he was expected to return.[67]

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[61] 1954 IRC § 267.

[62] *Musselman Hub-Brake Co.* v. *Commissioner* (6 Cir. 1943), 139 F. 2d 65 31 AFTR 1001.

[63] *Anthony P. Miller, Inc.* v. *Commissioner* (3 Cir. 1947), 164 F. 2d 268, 36 AFTR 250; *Commissioner* v. *Mundet Cork Co.* (2 Cir. 1949), 173 F. 2d 757.

[64] *P. G. Lake* v. *Commissioner* (5 Cir. 1945), 148 F 2d 898, cert. den'd. 326 U.S. 732 33 AFTR 1200. *Granberg Equipment Co.*, 11 T.C. 704 (1948).

[65] I.T. 3220, 1938—2 C.B. 164; see also *Commissioner* v. *Orton Ceramic Foundation*, (6 Cir. 1949), 173 F. 2d 483, where a charitable foundation exempt from tax operated a manufacturing and sales business and, out of its income, paid an annuity for the founder's widow.

[66] See footnote 45, above. See also 1954 IRC §§ 151, 152.

[67] *Kilpatrick*, U.S. D.C. S.D. of N.Y. April 21, 1952.

A binding agency contract based on a percentage of earnings is also a valid means of family income splitting. If (1) the portion of earnings provided as compensation for services rendered is reasonable, (2) the agreement was made before services were rendered, and (3) the agreement was at arm's length, the compensation will be allowable even though the dollar amount in some years may be high.[68]

Attention should also be directed to the possibility of compensating a son who gives ideas or establishes contacts beneficial to the business. If this can be shown, compensation is in order, even if the son is not otherwise present or engaged in the business.[69]

Caution should be exercised against claiming a deduction for a relative who renders no services or very minor ones. Not only will such a deduction probably be disallowed, but also there is a possibility that a claim of fraud may be made.

"Do's" and *"Don'ts"* in compensation agreements.

Do	*Don't*
Consider employing and compensating fairly family members. Consider employing family members in partnerships of non-relatives. Consider the requirements of Sec. 267 I.R.C. of 1954 with respect to payment of compensation within two and one-half months after the close of the taxable year. Consider payment by promissory note. Consider naming relatives as employees of taxpayer's charitable foundation.	Pay a minor child compensation and then use these funds or require that the child supply his own necessities. Attempt to claim a deduction for compensation paid to relatives who render no services, or very minor ones.

9. How to Operate Family Loan Agreements

Intrafamily loans, if bona fide, are of value for income tax purposes. The main income tax saving involved is an interest deduction to the borrower. In order to achieve any tax savings, it is clear that the taxable income of the lender must not be greater than that of the borrower. Where there is a bona fide loan, interest actually paid is deductible. Merely accruing interest does not give a deduction.[70]

There must be a legally enforceable obligation to pay both interest and principal in order to justify a deduction for interest paid. If family funds are commingled and the lender uses the funds, it has been held that a debtor-creditor relationship to support an interest deduction does not exist.[71] However, if a child's separate funds are borrowed and a promissory note supports the debt, an interest deduction is allowable.[72] The source of the funds involved in the debt does not affect the deductibility of interest. Thus, if funds have been received as a gift and subsequently loaned to the donor, a deduction for interest will be allowed if the loan is otherwise bona fide.[73] Payment of interest by one member of a family on a debt that is properly the debt of another member of the family is not deductible by either.[74]

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[68] *Olivia de Havilland Goodrich,* 20 T.C. No. 41 (1953).

[69] *Pucci,* 10 T.C.M. 5,29 (1951).

[70] 1954 IRC § 267. See also discussion of "accrued" vs. "paid" in Section 8 of this chapter.

[71] *Doverif,* T.C. Memo op. Dec. 13,545 (M).

[72] G.C.M. 13162, III-1 C.B. 110.

[73] *Steel,* 38 B.T.A. 589 (1938).

If an intrafamily debt proves worthless, a deduction for a bad debt is allowed to the lender.[75] However, if a wife's claim for dower makes it impossible to satisfy her claim as creditor,[76] or if no effort to collect the debt is made,[77] a deduction for a bad debt will not be allowed.

Deductibility turns wholly on the validity of the debt, expectation of repayment and efforts to secure repayment. Thus, where the burden of proof was sustained by one taxpayer, a bad debt deduction was allowed with respect to a debt owed by his brother;[78] in another case where the burden of proof was not sustained with respect to a loan to a daughter, the taxpayer's claim for a bad debt deduction was disallowed.[79]

When one member of a family pays amounts as a guarantor that are not recoverable, a bad debt deduction is allowed.[80] Also, where a wife or child purchases a debt owned by the husband-father from an outsider for less than face value, and there is a real substitution of creditors, the debtor realizes no income.[81]

"Do's" and *"Don'ts"* in family loan transactions.

Do

Consider loans from children.

Consider possibility of bad debt deduction where a loan to a relative is uncollectible.

Execute promissory note if deduction for interest is desired.

Pay interest due to a close relative within two and one-half months of close of taxable year.

Don't

Attempt to claim deduction for interest paid in intrafamily loans unless loans are bona fide.

Claim interest deduction on loan from a relative with whom you have a joint account if you commingle your funds.

10. How to Operate Family Rent Agreements

Rent paid by a person for use of property owned by a close relative constitutes a deductible expense item if (a) the rental is bona fide, (b) the rent paid is an ordinary and necessary business expense, and (c) the rent is not unreasonable.[82]

If the property was acquired in an arm's length transaction or with the private funds of the wife or child, no special problems are involved. If the property was acquired by gift from the husband-parent, or through a transaction that was not sufficiently separated, close scrutiny of the transaction may be involved; but if the transaction is bona fide, a deduction for rent will be allowed.

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[74] Except where a joint return by husband and wife is filed. *Colston* v. *Burnet* (D.C. Cir. 1932), 59 F. 2d 867, cert. den'd 287 U.S. 640, 11 AFTR 606.

[75] *Hetherington,* 20 B.T.A. 806 (1930).

[76] *Wheeler,* 40 B.T.A. 92 (1939).

[77] *Griffiths* v. *Commissioner* (7 Cir. 1934), 70 F. 2d 946 14 AFTR 225.

[78] *Levitz,* T.C. Memo 33741 (1952).

[79] *Kubitzki,* T.C. Memo 35683 (1952); See also *Clark Evans,* 18 T.C. No. 94 (1952); *McKay Products Corp.,* 9 T.C. 1082, reversed (3 Cir. 1949) 178 F. (2d) 639; cf. *Deputy* v. *Dupont,* 308 U.S. 488 (1940).

[80] *Ortez,* 42 B.T.A. 173 (1940).

[81] *Forrester,* 4 T.C. 907 (1944).

[82] *Floridian Hotel Operators, Inc.,* footnote 58 above; See also *Schreiber,* 6 T.C. 707 aff'd., (6 Cir. 1947) 160 F (2d) 108.

Thus, in a case in which a taxpayer transferred property to a trust under an irrevocable 20-year trust agreement with an independent trustee for the benefit of his wife and children and immediately rented the property from the trust for ten years at a fair rental, the rent was allowed as a deduction.[83] The fact that the taxpayer voluntarily created the situation that required the payment of rent was irrelevant since the payment of the rent was required, reasonable, and enforceable. Furthermore, it was held, the taxpayer's economic condition was changed notwithstanding the fact that he continued to occupy the same premises. Prior to the lease he had been an owner; as a result of the trust he separated himself from legal title and assumed an enforceable liability in the amount of the rent.

The Tax Court that had disallowed the rent deduction in the *Skemp* case[84] and was reversed has continued to disallow rent deductions in cases in which the good faith of the transaction was questionable. In one case,[85] a closed corporation, owned by husband and wife, was engaged in constructing airfields. The corporation sold to the wife certain equipment at book value under an agreement for the lease-back of such equipment at a fair rental. Since the wife did not have any cash, she borrowed funds for the purpose from a bank and used her stock as collateral. The first three months' rent equalled the purchase price. The Tax Court held this arrangement to be in effect a dividend to the wife rather than rent. The basis for the opinion seemed to be that calling an item "rent" did not necessarily make it so, if all the surrounding facts pointed to the nonexistence of a genuine sale or transfer. The Court stated that the corporation never gave up its right to use the equipment. A concurring opinion was based on distinguishing the facts found in Armston. A dissenting opinion states that the reasoning of the *Skemp* case applies equally to this case. Assuming that the transaction is not a sham,[86] the reasoning of the Seventh Circuit Court in the *Skemp* case seems supportable under the law and cases on the subject.

The general rule that payment between close relatives must be paid within two and one-half months after the close of the taxable year applies with equal force in the case of rents.[87]

Considerable variety may exist in rental arrangements between close relatives. Some of these are as follows:

1. "A" rents from his close relatives property that was purchased by independent funds or by funds obtained from "A" as a gift or a bona fide loan.
2. "A" transfers stock in a corporation that owns property to his wife or children and rents the property from the corporation.
3. "A" and his wife are a partnership, which may or may not be recognized for Federal income tax purposes. His wife acquires property with her share of the partnership profits and rents the property to "A."
4. "A" transfers property by gift to his close relatives with a lease-back arrangement.

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[83] *Skemp* v. *Commissioner*, see footnote 49, above. See also *Sam Newman, et al.*, T.C. Memo No. 30656 (1953) cf. *Welworth Realty Corp.*, 40 BTA 97; E. *Field White* v. *Fitzpatrick*, D.C., Conn. 51-1 VSTC 9183, aff'd (2 Cir. 1951) 193 F. (2d) 398, cert. den'd 343 U.S. 928; *Felix*, 21 T.C. No. 90 (1954); See Rev. Rul. 54-9 IRB 1954-2, 5.

[84] 8 T.C. 474 (1947).

[85] *Armston*, 12 T.C. No. 71 (1949).

[86] See *Johnson* v. *Commissioner* (2 Cir. 1936), 86 F. 2d 710 18 AFTR 650.

[87] See discussion of 1954 IRC § 267 in Section 7 of this chapter.

Indefinite rental agreements should be scrupulously avoided. Thus where rent paid voluntarily by husband to wife was voluntarily increased based on a percentage of net profits, the increase was not deductible because it exceeded a fair rental.[88] Similarly where there is no specific obligations to pay any fixed rental, any amounts in excess of a fair rental will be disallowed.[89] Definite percentages would appear acceptable.[90]

Collateral risks arising from indefinite and unreasonable rent arrangements also arise. For example, excess rents may be deemed to be a dividend to the stockholder even though paid to the wife.[91] Also, disallowed rents may increase corporate income to a point where a penalty may be imposed upon the corporation for gross understatement of income or failure to file an excess profits tax return.

"Do's" and *"Don'ts"* in family rental agreements.

Do	*Don't*
Consider renting property from close relatives for business purposes.	Attempt rental arrangement that has no substance.
Frame rental agreement so that (a) obligation is enforceable; (b) rent is reasonable; (c) rent is definite.	Have voluntary or indefinite rent arrangements.
Transfer property in anticipation of rental, but be certain that the transfer is complete so that ownership is effectively transferred.	

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[88] *Roland P. Place,* 17 T.C. No. 23 (1951) cf. *Stanley Imerman,* 7 T.C. 1030 (1947).

[89] *Manos Amusements, Inc.,* T.C. Memo No. 25073 (1951).

[90] In the *Manos* case, footnote 89 above, the court stated that petitioner was not obligated to pay rental "on any fixed basis such as . . . a guaranteed minimum plus graduated percentages of gross income . . . or a fixed percentage of gross." cf. *Place,* footnote 88 above, where percentages were involved but it was a voluntary arrangement.

[91] *Limencks Inc.,* 7 T.C. 1129 aff'd. (5 Cir. 1948) 16 F. (2d) 483; *Charlies Cafe Exceptionale, Inc.* T.C. Memo C.C.H. 15,579; cf. *A & A Tool and Supply Co.* v. *Comm'r.* (10 Cir. 1950), 182 F. (2d) 300.

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The Family Partnership as an Income-Splitting Technique

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Under the graduated income tax, substantial gains can be made by the taxpayer who splits up his income among family members.[1] The greater income taxable to the family head at a higher surtax rate may be divided into lesser incomes taxable to the family members at lower rates, and the shifted income can still serve the breadwinner. It can take the place of allowances or savings funds he otherwise would have financed directly. Of course, the husband-wife joint return provisions of the 1948 Revenue Act do narrow the benefits of income splitting by permitting husbands and wives to compute their income tax as if the breadwinner's income were earned by both of them.[2] But there are still large savings to be made by allocating income among children and other close relatives.

Most popular of the income-splitting devices today is the family partnership.[3] This is not surprising since the family partnership offers the taxpayer who has no income-producing property other than his business an easy method of dividing his income among family members. Moreover, it permits greater managerial controls over the source of the income than other techniques.

The need for an understanding of family partnership law on the part of lawyers and laymen can be argued solely on the usefulness of the family partnership as an income-splitting technique. But there is more reason than that. For under the Internal Revenue Code[4] partnerships among spouses, ancestors or lineal descendants may be treated alike, whether or not they were motivated by a desire to apportion income. And it is quite conceivable that even the non-family partnership at some time or another may find itself entwined in one of the tentacles of this complex law.

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[1] A clear illustration of these savings is found in Packel, "The Next Inning of Family Partnerships," *U. of Pennsylvania Law Review*, Nov. 1951, Vol. 100, page 153. As demonstrated in this article, a breadwinner with $150,000 a year business income could save approximately $35,000 in taxes each year if he could divide his income with two minor daughters.

[2] 1954 IRC § 6013; 1939 IRC § 51(b); Revenue Act of 1948, §§ 301 et seq., 62 Stat. 110.

[3] For fuller discussion see Comment, "Family Partnerships and the Revenue Act," *Yale Law Journal*, April 1952, Vol. 61, page 542 note 2.

[4] The family partnership provisions of the Code, 1954 IRC §§ 704(e)(1), 704(e)(2), 704(e)(3); 1939 IRC §§ 3797, 191, were introduced by the Revenue Act of 1951, Pub. Law No. 183, 82d Cong., 1st Sess. (Oct. 20, 1951).

1. Points to Consider

The principal points to be considered are as follows:

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Establishing the family partnership	2
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Recognition of partnership interest	6
Reallocation of donee income	7
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The donee in military service	9
The law governing pre-1951 tax returns	10

2. Establishing the Family Partnership

Formation of a family partnership is essentially simple. The owner of an enterprise can make a family member partner to his business by formal or informal agreement. Usually the partnership interest is donated to the family member, though at one time the trend was to make the transfer appear like a sale. Possible, too, is the establishment of a sub-partnership. By this method the owner of a partnership interest in a business may share that interest with a member of the family without disturbing the basic partnership.[5] The form of interest donated in either case depends on the desires of the parties. Most often the interest is much like that of a limited partner. The new member contributes no services and his liability is limited to the value of his interest.

3. Taxation of the Family Partnership—The Issue

Under the Internal Revenue Code, income to a partnership generally is taxable to the individual partners according to their distributive shares under the partnership agreement.[6] Given a family partnership recognized under state law, theoretically all that would be necessary to split the business income for tax purposes is a provision in the partnership agreement apportioning the profits among the partners. However, because the family partnership offers so much leeway for tax avoidance,[7] the usual rule is not applied indiscriminately or unqualifiedly. And so in the case of any family partnership these questions must be decided; under what conditions and to what extent will the imposition of income tax follow the distribution of income under the partnership agreement.

Deciding these questions in the past, the courts have carried into the field of family partnership principles developed in other income-splitting cases. In applying these principles, however, the courts at different times have come to different conclusions. More recently with the 1951 Revenue Act, Congress has tried its hand at composing a satisfactory set of laws for the family partnership. The 1951 Act, though, is applicable only with respect to the taxable year 1951 and those following. Judicially evolved rules still govern pre-1951 returns. The following analysis will therefore consider first some highlights in the development of the judicial rules. This will be followed by a study of the Act as it applies to 1951 and subsequent returns, and finally conjecture as to its effect on the judicial laws governing pre-1951 returns.

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[5] See, *United States* v. *Atkins*, (5 Cir. 1951), 191 F. 2d 146, 40 AFTR 1195. If a sub-partnership is employed the facts of the venture should be defined clearly before income is earned. This is best done by some written partnership agreement delineating all aspects of the partnership relation. See, *Forman* v. *Commissioner* (9 Cir. 1952), 199 F. 2d 881, 42 AFTR 869 remanding par. 51,106 Prentice-Hall Memorandum T.C. (1951).

[6] 1954 IRC §§ 701, 702, 704; 1939 IRC §§ 181, 182.

[7] See footnote 3, above.

4. The Family Partnership in the Courts

General principles. The law of family partnership has been greatly influenced by doctrines evolved to deal with other income-splitting devices.[8] In the landmark case of *Lucas* v. *Earl*[9] the Supreme Court announced that income derived from personal services is taxable to the person who earned it. Assignment of income already earned or to be earned in the future cannot shift the tax from the income producer. Where, however, the income is produced by property rather than by services, and that property is given to another, the income tax will shift to the donee with the change in ownership of the property. This is the rule of *Blair* v. *Commissioner*.[10] The gift, though, must be complete. The decisions in *Helvering* v. *Horst*[11] and *Helvering* v. *Clifford*[12] warn that the incidence of taxation on income cannot be shifted if the donor retains the property producing that income or significant attributes of ownership in the property.[13]

Specific applications. In the period before the first Supreme Court decision on the family partnership in *Commissioner* v. *Tower*,[14] the lower courts judged the family partnership by these general standards.[15] The initial question was whether the partnership was a personal services business, in which case income could not be assigned. Most decisions, though, turned on whether or not the partnership gift was complete. And results varied with the stringency of the completeness test.[16] The *Tower* case put the issue squarely up to the Supreme Court in 1946.[17] It involved a husband-wife partnership in which the wife performed no services and in which her capital contribution originally had been a gift from her husband. The Court denied the validity of the partnership for tax purposes. But it did point out that a wife and husband could become partners for tax purposes "If she either invests capital originating with her, or substantially contributes to the control and management of the business, or otherwise performs vital additional services. . . ."[18] In the lower courts this phrase was seized on as offering the only concrete criteria for upholding a family partnership.[19] But *Commissioner* v. *Culbertson*[20] soon changed that. In that case the Supreme Court was asked to straighten out one of the kinks *Tower* left in the family partnership law; whether the new partner's intention to contribute future capital or services was sufficient to validate a family partnership. The court held that it was not. Then, in an unexpected about face, the court corrected what it considered misconceptions engendered by the *Tower* opinion. The three criteria of the *Tower* opinion were not controlling, it said. The partner's intent to form a genuine partnership was all that mattered. The essential question was whether

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[8] See generally, Soll, "Intra-Family Assignments: Attribution and Realization of Income," *Tax Law Review*, May 1951, Vol. 6, page 435 and *Tax Law Review*, Nov. 1951, Vol. 7, page 61; Ryan, "Federal Tax Treatment of the Family," *Marquette Law Review*, Feb. 1949, Vol. 32, page 244.

[9] 281 U.S. 111, 8 AFTR 10287 (1930). See also, *Burnet* v. *Leininger*, 285 U.S. 136, 10 AFTR 1601 (1932).

[10] 300 U.S. 5, 18 AFTR 1132 (1937). The donor assigned to his daughter his life interest in certain trust income. Holding this to be a gift of "equitable" property for tax purposes, the Court refused to tax the donor on the income.

[11] 311 U.S. 112, 24 AFTR 1058 (1940). In this case the owner of negotiable bonds had transferred the unmature coupons to his son who collected them at maturity the same year. Nevertheless, the interest was taxed to the donor. The Court pointed out that income was realized by the assignor "because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." *Id.* at page 116, 1061. See also, *Harrison* v. *Schaffner*, 312 U.S. 579, 25 AFTR 1208 (1941).

[12] 309 U.S. 331, 23 AFTR 1077 (1940). In this case the Court taxed the settlor of a trust on the trust income because the Court was convinced by the short duration of the trust, the fact that settlor's wife was beneficiary and the settlor's power to invest the trust's funds and vote its stock, that the trust did not effect any substantial change in the settlor's economic position.

[13] Sections 166 and 167 of the 1939 Code (1954 IRC §§ 676, 677) provided for taxing the settlor on income to revocable trusts, or to trusts where the income could be used for his benefit. These sections were inapplicable in the *Clifford* case and the Court taxed the trust to the settlor under section 22(a). The 1954 Internal Revenue Code in sections 671, 672, 673, 674 and 675 incorporates the *Clifford* directive and subsequent Clifford regulations into law. See footnote 55.

[14] 327 U.S. 280, 34 AFTR 799 (1946).

> . . . considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of the income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.
>
> Unquestionably a court's determination that the services contributed by a partner are not 'vital' and that he has not participated in 'management and control of the business' or contributed 'original capital' has the effect of placing a heavy burden on the taxpayer to show the bona fide intent of the parties to join together as partners. But such a demonstration is not conclusive. . . .[21]

The *Culbertson* opinion has left a train of uncertainty.[22] Its overall effect has been to loosen the restrictions binding family partnerships. But that seems more a result of the feeling it showed than a clearly enunciated approach to the issue. Post-*Culbertson* decisions have turned on any one of three rationales. Some few diehard courts still have applied the *Tower* criteria but have paid obeisance to *Culbertson* by couching their conclusion in terms of "intent." [23] Most, however, have felt that *Culbertson* demanded more than mere change of terminology. The large number have probed for a subjective intent, seeking it by the pre-*Tower* standards and completeness of gift tests.[24] Others have added to pre-*Tower* rules the requirement of a business purpose for the partnership. This requirement has been satisfied, generally, when the new partner is necessary for an extension of partnership credit.[25]

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[15] See Comment, *op. cit.*, footnote 3, above, at page 542-543. See also cases listed in Prentice-Hall Tax Service, 1955, Vol. 2, par. 15,529.

[16] See Lifton, "The Family Partnership: Here We Go Again," *Tax Law Review*, May 1952, Vol. 7, page 464.

[17] Accompanying the *Tower* case to the Supreme Court was *Lusthaus* v. *Commissioner*, 327 U.S. 293, 34 AFTR 806 (1946). In this case the wife received shares in her husband's wholly owned corporation three days before he converted it into a partnership. After the conversion she turned in the assets represented by her shares for a partnership interest. Although Mrs. Lusthaus rendered some services to the corporation she took no part in its management.

[18] *Commissioner* v. *Tower*, 327 U.S. 280, 290, 34 AFTR 799 (1946); Prentice-Hall Federal Tax Service, 1955, Vol. 2, par. 15,528.

[19] See Lifton, *op. cit.*, footnote 16, above, page 465.

[20] 337 U.S. 733, 37 AFTR 1391 (1949). This case is discussed extensively by the commentators. See e.g. Bruton, "Family Partnerships and Income Tax—Culbertson Chapter," *U. of Pennsylvania Law Review*, Dec. 1949, page 143; Note, "Income Taxation of Family Partnerships," *Columbia Law Review*, Jan. 1950, Vol. 50, page 88.

[21] 337 U.S. 733, 742, 744; 37 AFTR 1391, 1395, 1396 (1949).

[22] See Packel. *op. cit.*, footnote 1, above, at page 155; Walker, "Family Partnerships Since Culbertson," *Arkansas Law Review*, Summer 1950, Vol. 4, page 316. See cases listed in Prentice-Hall Federal Tax Service, 1955, Vol. 2 par. 15,512 *et seq.*

5. The Revenue Act of 1951

With the hope of resolving the family partnership question once and for all, Congress enacted Section 340 of the Revenue Act of 1951. The overall aim of the section was "to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business." [26] Thus, Congress meant to tax income from property to the person owning that property and to tax income from services to the person rendering those services.[27] To achieve this, the section added two amendments to the 1939 Code. Section 3797 of the Code which contained a definition of partnership was amended to include the following:

> A person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.[28]

And a new section—191—was added to the operative partnership provisions, stating:

> In the case of any partnership interest created bv gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater

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[23] See e.g. *W. F. Harmon*, 13 T.C. 373 (1949).

[24] See Note, *op. cit.*, footnote 20, above, at 73-77; Comment, "Taxation of Family Partnership Income—The Tower Doctrine Reinterpreted," *U. of Chicago Law Review*, Spring 1950, Vol. 17, pages 501-508.

[25] See e.g., *O. H. Delchamps*, 13 T.C. 281 (1949); *Greenberger* v. *Commissioner* (7th Cir. 1949), 177 F. 2d 990. 38 AFTR 1008. Absence of a tax avoidance motive was also stressed in the *Greenberger* case. See also, *Clarence B. Ford*, 19 T.C. 29 (1952); Prentice-Hall Federal Tax Service, 1955, Vol. 2, par. 15,521.

[26] H. R. Rep. No. 586, 82d Cong., 1st Sess. 34 (1951).

[27] H.R. Rep. No. 586, 82d Cong., 1st Sess. 32 (1951): "There is no reason for applying different principles to partnership income. If an individual makes a bona fide gift of real estate, or a share of corporate stock, the rent or dividend income is taxable to the donee. Your committee's amendment makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of a new partner."

[28] Pub. Law No. 586, 82d Cong., 1st Sess. § 340(a) (Oct. 20, 1951); 1954 IRC § 704(e)(1); 1939 IRC § 3797(a)(2).

than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service. For the purpose of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The 'family' of any individual shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons. . . . The determination as to whether a person shall be recognized as a partner for income tax purposes for any taxable year beginning before January 1, 1951, shall be made as if this section had not been enacted and without inferences drawn from the fact that this section is not expressly made applicable with respect to taxable years beginning before January 1, 1951. . . .[29]

These provisions have been included without significant modification in the 1954 Code.

6. Recognition of Partnership Interest

Capital interest. The first requisite for recognition as a partner is ownership of a capital interest in the business. This means that the person must own an interest in the capital of the partnership, including all accretions to that capital, which is distributable to him upon his withdrawal from the partnership or upon dissolution or liquidation of the partnership. The Treasury Department has instructed that it will not recognize the mere right to participate in the earnings and profits of a partnership as a capital interest.[30]

Capital as a material income-producing factor. The statute recognizes as a partner the owner of a capital interest in a business only if capital is a material income-producing factor in that business. This provision applies to non-family businesses as well as family enterprises. It is homage to the *Blair* directive that a transfer of income-producing property shifts the tax incidence on the income produced by that property. And the requirement that capital be a material income producer is consistent with the *Lucas* v. *Earl* doctrine that income must be taxed to the person who earns it. It is an attempt to exclude from the auspices of the section gifts of partnership interest in businesses where the major portion of income is earned by the donor rather than by the donated capital.

When is capital a material income-producing factor? A guide is offered by the Treasury Regulation which states that "capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business. . . ." [31] In most business the issue is easily resolved. If operation of the partnership requires substantial investment in realty, plant, machinery or equipment, or large inventories, a transfer of a capital interest ordinarily will not be invalidated under this section. And there are a few cases where capital is clearly not essential. Some artists, authors and entertainers, for example, can attribute their income almost solely to their personal efforts and abilities rather than any other assets. Unfortunately, there are some borderline situations. These are primarily of two kinds: the first involves artisans and professional men who produce the greater part of their income by their own efforts yet are beholden to their equipment as well;[32] the second, personal service concerns with staffs of employees. Various approaches are open in cases of this sort to determine whether capital is a material income-producing factor.

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[29] Pub. Law. No. 586, 82d Cong., 1st Sess. § 340(b) (Oct. 20, 1951); 1954 IRC § 704(e)(2) and 704(e)(3); 1939 IRC § 191.

[30] Reg. 118, §39.191-1(a)(5).

[31] Reg. 118, § 39.191-1(a)(4).

One method for determining the materiality of capital is to attempt a direct comparison of the income earned by capital with the total partnership income. The vulnerability of this method lies partially in the fact that there is no way of measuring the income actually earned by capital. At best, an approximation can be made by compensating capital for its rental by what is deemed a fair return in the industry concerned. And to base a decision as to whether income is earned by personal services—which is the real issue—on a comparison of a fair return on capital with total income, is difficult to defend economically. For the total income is not only the result of capital and services. It is enhanced too by such factors as good will, the combination of employer-employee efforts and the economic situation of the concern as a going business.[33] Finally, there is no more reason in any case for applying the measure of materiality offered by the Commissioner, say, than that suggested by the taxpayer.

Actually, the courts probably will not attempt so strict a computation of materiality. They may be tempted, though, by techniques developed in other areas of tax law requiring a similar decision. In dealing with the earned income credit[34] and personal service corporation provisions,[35] the courts have attempted loosely to classify enterprises as personal service or non personal service businesses.[36] And this was the practice adopted generally in the pre-*Tower* family partnership decisions.[37] Under this criterion, where the enterprise is classified as a personal service business, capital will be deemed immaterial.

In the fringe areas under discussion where the issue is likely to arise, however, such a test merely begs the question. Usually the enterprise concerned is one that at first blush would fall into the general category of personal service business. The real question is whether the peculiar circumstances of that concern call for a different treatment.[38] For materiality, like any other factual issue, must be decided on the facts of the particular case. This requires consideration of the type of business, of course. But it also means looking into such factors as the total amount of capital invested, the use made of such capital, the importance of the capital to the life of the specific concern, and the relationship of income to services.[39] Factual arguments by the taxpayer along these lines undoubtedly will be the most effective.

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[32] The dentist's equipment and the plumber's tools are examples of this.

[33] For a fuller discussion of this point see Robinson, "The Allocation Theory in Family Partnership Cases," *Taxes*, Nov. 1947, Vol. 25, page 963.

[34] See 1939 IRC § 25(a)(4), Reg. 111, § 29.25-2 (1941), repealed by section 107 of the Revenue Act of 1943. A similar provision is contained in 1954 IRC § 911; 1939 IRC § 116(a)(3), Reg. 118, § 39.116-1. Both sections provide a ceiling on the proportion of profits of a trade or business which can be considered earned income if the trade or business is one in which "both personal services and capital are material income producing factors." The regulations state: "No general rule can be prescribed defining the trades or businesses in which personal services and capital are material income-producing factors, but this question must be determined with respect to the facts of the individual cases."

[35] Revenue Act of 1921, §§ 200(5), 218(d), 42 Stat. 228, 245 (1921). The Act defined a personal service corporation as one whose income was ascribable primarily to activities of the principal owners or stockholders who were themselves engaged in active conduct of the affairs of the corporation, and one in which capital was not a material income-producing factor. Such a corporation was exempt from taxation.

[36] See e.g., *Fred C. Sanborn*, 19 B.T.A. 495 (1930); *Shipley School* v. *McCaughn*, (3rd Cir. 1929) 34 F. 2d 281, 7 AFTR 9323.

[37] See Judge Mellott's concurring opinion in *Camiel Thorrez*, 5 T.C. 60, 69 (1945).

[38] See discussion, Lifton, *op. cit.*, footnote 15 above at page 469. Even in interpreting the earned income credit and personal service corporation provisions, some courts have clearly implied that capital may be a material income-producing factor despite its employment in what is essentially a personal service business. See, e.g., *Atlanta-Southern Dental College* v. *Commissioner*, (5th Cir. 1931) 50 F. 2d 34, 9 AFTR 1552; *Isidore Garnets*, 26 B.T.A. 384 (1932).

While this factual analysis may suffice to uphold a partnership with an artisan or professional man, in the case of professional concerns like engineering, stock brokerage, law and architectural firms an additional proposition may be advanced: that capital in such concerns has a special nature. The taxpayer may find success by convincing the courts to view capital in this situation as representing more than mere physical assets.[40] In personal service concerns, often heavily staffed, the business income is hardly attributable either to the donor's services or his employees' efforts alone. It is a product of the combined services of both, as well as the enterprise's value as a going concern. This combination of services and going concern value, the donor may contend, is actually the capital of the business—and its materiality must be determined. Some idea of materiality might be arrived at by comparing the employees' salaries plus a fair salary attributable to the donor with total partnership income.

One other point should be mentioned. Even where capital is not material in the business, under any test, a partnership interest transferred in return for vital services will be upheld. Before the passage of the Act, interests granted in return for vital services were recognized even under the stringent *Tower* criteria.[41] That Congress meant to terminate recognition of these interests in an Act generally intended to broaden the scope of recognition probably will not be argued by the Commissioner nor accepted by the courts.[42]

The trust as a partner. By defining the word "person" to include a trust, the Code has paved the way explicitly for use of the trust as a partner.[43] This may be of considerable advantage to the married but childless taxpayer who now can split his income three ways by utilizing the joint return and establishing a partner trust for his wife. A taxpayer with a single child can now apportion his income at least five ways: to himself; to his wife under the 1948 income splitting provision; to his child; to a trust for his wife; to a trust for his child. Of course there are some restrictions on this technique. Before the 1954 Revenue Act in order for the trust income to be taxable to the trustee rather than the beneficiary the trust must have been an accumulation trust with the income not currently distributable under the terms of the trust.[44] The 1954 Act further circumscribes this technique by taxing to the beneficiary any distribution by a trust in excess of its distributable net income for the current taxable year to the extent that such income was not in fact distributed during the five preceding years.[45] Still this is no overwhelming obstacle since for each year over five that the income is accumulated it is not taxed to the beneficiary. Long accumulations can take the place of savings or insurance plans that might otherwise have been established to provide security for the wife or child.

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[39] See Reg. 111, § 29.25-2 which illustrated the computation of the earned income credit now repealed. See footnote 34 above; Packel, *op. cit.*, footnote 1, above.

[40] This concept has been accepted by the courts in cases involving the sale of partnership interest. See, *Commissioner* v. *Shapiro* (6th Cir. 1942), 125 F. 2d 532, 535, 28 AFTR 1079, 1082 "Respondent sold all of his interest in the partnership, tangible and intangible, as a going concern, which in all essentials is different from the ordinary assets of the partnership used in the usual course of its business."

[41] See, e.g., *Larson* v. *Kraemer* (D. Conn. 1949) 84 F. Supp. 313, 37 AFTR 1556; *Roy C. Fleeman* v. *Commissioner*, 7 T.C.M. 770, 774 (1948). See cases cited in Prentice-Hall Federal Tax Service, 1955, Vol. 2 par. 15,516.

[42] Of course, the Code can be read to refuse recognition to such interest. For such interests are not capital and they may be in concerns where capital is not a material income-producer as well as where it is. But it is difficult to defend the contention that the Code was meant to be exclusive—that is, that the only partnership interest recognized is a capital interest in a concern where capital is material. This interpretation would mean the end of tax recognition of almost all professional partnerships. Rather, it must be concluded that the section was meant to expand the restrictive rules current at the time of its enactment. And even under those rules the interest based on vital services was recognized.

[43] "The term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, company or corporation." 1954 IRC § 7701(a)(1); 1939 IRC § 3797(a)(1). See Prentice-Hall Federal Tax Service, 1954, Vol. 2, par. 15,506.

Perhaps the most intriguing question to arise out of Congressional sanction of the trust partner is this: can the taxpayer divide his income into innumerable parts simply by establishing a number of trusts for each relative and investing each trust with a partnership interest? There are no apparent legal obstacles to the use of multiple trusts,[46] especially if different trustees are used. By employing multiple trusts which accumulate income for different periods of years over five the taxpayer can achieve the effect of a single trust the income of which is currently distributable, but the trust and not the beneficiary will be taxed.

Validity of gift or purchase. Although no language in the Code makes validity of the gift or purchase one of the conditions to tax recognition of the partnership, the Committee reports on the 1951 Act expressly suggest that "the Commissioner and the courts. . . . inquire in any case whether the donee or purchaser actually owns the interest in the partnership which the transferor purports to have given or sold him." [47] And even without this legislative encouragement, the courts undoubtedly would scrutinize the facts surrounding a transfer to determine whether it was legitimate or whether the grantor retained so many incidents of ownership that under the *Clifford-Horst* doctrine he should be recognized as the real owner of the interest.

The large number of combinations of circumstances which may make a gift or purchase suspect prevents comprehensive categorization.[48] However, the most usual controls may be examined in the light of past decisions to determine how close they approach to a danger zone. Moreover, the Internal Revenue Service recently has enumerated some of the controls it will challenge[49] and this offers a fairly good diagram of the pitfalls to be avoided.

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[44] See, Comment, *op. cit.*, footnote 3 above at pages 548-550.

[45] The 1954 Act attempts to carry out the concept that the trust is merely a conduit of income and that the beneficiary should be placed in the same position as if the trust made the distribution at the time it received the income. To this end it provides for "throwing back" any distribution by the trust in excess of its distributable net income for the current taxable year to each of the five preceding years in inverse order and taxing it to the beneficiary to the extent that the distributable net income for the year was not distributed. 1954 IRC § 641 *et seq.*

[46] Compare with this view the one expressed in Comment, *op. cit.*, footnote 3, above, page 549.

[47] H.R. Rep. No. 586, 82d Cong., 1st Sess. 35 (1951). The Treasury regulations make it clear that the validity of every gift will be studied. "To be recognized a transfer must vest dominion and control of the partnership interest in the transferee. . . . Transactions between members of a family will be closely scrutinized, and in the case of such transactions the circumstances at the time of a purported transfer and during periods preceding and following it will be taken into consideration in determining the bona fides or lack of bona fides of the purported gift or sale." Reg. 118, 39.191-1(a)(3).

[48] See Haskell, "Capital Contributions and 'Business Purpose' In Family Partnerships," *Minnesota Law Review*, June 1949, Vol. 33, pages 723-737.

Where the donee of a capital interest receives the right to withdraw his interest at will and managerial powers commensurate with his interest the gift will be held complete. But if the donee would not be free to withdraw his interest whenever he is dissatisfied with the administration of the business, the courts will probably disregard the gift, even if the donee has some managerial power.[50] Of course, what constitutes freedom to withdraw is subject to controversy. Fetters contained in the partnership agreement itself may invalidate the gift for tax purposes. Certainly, outright restrictions on withdrawal will not withstand scrutiny. Questionable also are clauses requiring the donee to leave his interest in the business subject only to his right as a partner to bring about dissolution and an accounting by court decree upon proof of wrongdoing by or unfitness of the partners. If the donee cannot withdraw his interest without financial loss his freedom also may be considered too limited. Such restriction may be found where the partnership agreement has a clause in it permitting the donor-partner to buy the donee's interest at a fixed low price.

Even if the donee has full power to withdraw his interest, however, certain other controls retained by the donor may make the gift merely nominal. Thus the donor may retain ownership of essential assets leased at will or for a short term to the partnership. Or he may control the income of the partnership by owning a nominally separate business organization of which the partnership is only an adjunct, or on which it depends for its income. In these instances the value of the donee's interest fluctuates according to the donor's whim.

In most cases involving a family partnership the donee's position is similar to that of the usual limited partner. The partnership income is not completely dependent on the donor's action, and the donee's interest can be withdrawn at will. However, the donor does retain managerial control over the business, including the power to distribute the income or reinvest it in the business. The Committee's report on the 1951 Act warns that "not every restriction upon the complete and unfettered control by the donee of the property donated will be indicative of sham in the transaction. Contractual restrictions may be of the character incident to the normal relationships among partners. Substantial powers may be retained by the transferor as a managing partner or in any other fiduciary capacity which, when considered in the light of all the circumstances will not indicate any lack of true ownership in the transferee."[51] Certainly the limited partnership is no unusual relationship between partners and so the Committee's report may have resolved the issue. However, the report, though influential, is not binding on the courts. Moreover, it should be remembered, that in the family partnership the limitations are frequently on the donee's rights rather than his liabilities.

The courts themselves have not taken a decided stand on the question. Retention of business control by the grantor and the concomitant power to direct the ebb and flow of income in analogous situations has led to disapproval of the gift by some courts, approval by others.[52] With the issue thus unresolved a donor would be well advised to take no unnecessary chances. The safest course is to distribute to the donee partner all, or a large portion, of his share of the income. And this income should not be deposited, loaned or invested in such ways that the donor can control its use or enjoyment. If income must be retained in the partnership it would be wise to show agreement by all partners to that action, or evidence that such retention is clearly to satisfy the reasonable requirements of the business. Where feasible, the partnership agreement should vest managerial powers in the donee commensurate with his interest. Significant partnership decisions should be made only after consultation with the donee. And perhaps it would be wise to hold regularly scheduled business meetings at which the donee is present. Certainly the donee should be held out publicly as a partner in the conduct of the business, in relations with customers, or with creditors or other sources of financing. Such divers matters as the written partnership agreement, capital and drawing accounts, insurance policies, bank accounts, leases and other business contracts and litigation affecting the business all should reflect the fact that the donee is a recognized partner.[53]

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[49] Reg. 118 § 39.191-1(b).

[50] *Cf. Francis E. Tower,* 3 T.C. 396 (1944); *O. William Lowry,* 3 T.C. 730 (1944); *Carl P. Munter,* 5 T.C. 39 (1945).

[51] H.R. Rep. No. 586, 82d Cong., 1st Sess. 33 (1951).

If the donor prefers that the donee does not participate in managerial decisions, chances of partnership recognition are far greater if the donee is made a true limited partner within the technical requirements of state law.[54] But even if local law is complied with, retention by the donor of controls restricting those rights ordinarily accorded a limited partner may indicate to the courts that the partnership is not real.

Trusts. Where the trust is a partner, the Commissioner's attack on distribution of partnership income can come from either or both of two directions. First, the attack can be made on the trust itself under the *Clifford* doctrine. In this vein the Commissioner can argue that the gift of the partnership interest to the trust was not a real gift because the grantor retained so many controls *over the trust* as to remain substantial owner of the interest.[55] The Commissioner may also contend, as in the non-trust partnership, that the grantor has retained such controls *over the partnership* that although the trust as such may be independent, as a partner it is subservient to the grantor. Most invulnerable to these attacks is an arrangement where the trustee is independent of the grantor and responsible as a fiduciary for his conduct; the grantor retains no substantial controls of the trust corpus or income; and the trustee as a partner participates in management and receives actual distribution of all or a major part of the partnership income due him. This is not to say that where the grantor is trustee the partnership can never survive the probings of the courts. In such case an important argument for recognizing the partnership will be the fact that the trust is treated as a real partner by customers and creditors in their business dealings with the partnership. In addition, partnership income probably will be traced to determine whether income not retained for legitimate business needs finds its way through the trust into the beneficiary's hands or into investments or savings for the beneficiary's interest.[56]

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[52] See Lifton, op. cit., footnote 16, above, page 472.

[53] Reg. 118 § 39.191-1(b)(6).

[54] See Ballantine, *Corporations* § 3 (1946).

[55] Under the 1939 Code the attack on the trust can be made using sections 166 and 167 or the *Clifford* rules of section 22(a). Section 166 applies where there is vested in the grantor (or in a person not having a substantial adverse interest) a power to revest in the grantor the corpus of the trust. Section 167 applies to trusts the income of which may be distributed to the grantor directly, accumulated for future distribution to him or applied to the payment of insurance policies on his life. As construed by the Supreme Court in *Helvering* v. *Clifford* (see footnote 12, above) section 22(a) will tax the income of certain other trusts to the grantor where he is considered to be the owner. These include certain short term trusts providing for reversion to the grantor at the end of the term and trusts where the grantor has retained the power to determine which beneficiary will enjoy the income. The principles for determining taxability of these trusts have been the subject of detailed regulation. Reg. 118, § 39.22(a)-21.

Under the 1954 Code, the rules for determining taxability of trusts falling within the purview of section 22(a) as well as those covered by section 166 and 167 are brought together. While in general the criteria for determining taxability under the *Clifford* doctrine follow the pattern of the regulations, that is, the dominant types of control are stated to be (1) the reversion of the trust property within a short period after creation of the trust; (2) the reservation of power to determine who should enjoy corpus or income; and (3) the reservation of important administrative controls in a non-fiduciary capacity, there are variations in the precise standards selected. H.R. Rep. 1337, 82d Cong., 2d Sess. A211 (1954).

Minors as partners. Where the partnership interest is donated to a minor the courts probably will establish stricter tests of whether the gift is complete than when an adult is made partner. Children rarely are capable of understanding and properly exercising their rights. A minor child may be considered competent to manage his own affairs if he actually has sufficient maturity and *experience* to be treated by disinterested persons as competent to enter business dealings or otherwise to conduct his affairs on a basis of equality with adults. If that is not the case, the courts may feel that even freedom to withdraw from the partnership at will is not sufficient guarantee of the minor's independence of the grantor. Here, as in the case of trusts, recognition of the child as real owner may well hinge on whether his interest is guarded by a fiduciary subject to judicial supervision.[57] Moreover, use of the child's property or income to pay his support for which the grantor is legally responsible may lead to condemnation of the gift as unreal.

7. Reallocation of Donee Income

The provision for reallocation of donee income among the partners for tax purposes is probably one that will present the most difficulty to the taxpayer and the courts. Conceived in early Tax Court cases, the allocation principle was soon rejected by the courts.[58] As a result, a clear statement of the principle has never been forged in the fires of litigation.

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[56] See e.g., *Thomas H. Brodhead,* 18 T.C. 726 (1952); *Edmond D. Sultan,* 18 T.C. 715 (1952); *Louis R. Eisenmann,* 17 T.C. 1426 (1952). Reg. 118, § 39.191-1(b)(7).

[57] Judicial supervision of the fiduciary's conduct includes the proper filing by the fiduciary of those reports and accountings required by law of the fiduciary who participates in the affairs of the partnership on behalf of the minor. Reg. 118, § 39.191-1(b)(8).

[58] The allocation principle had its birth in *German* v. *Commissioner,* 2 T.C. 474 (1943). There the court found that the taxpayer and his wife were engaged in a joint venture rather than a partnership and re-allocated the business income between them. In 1945 the principle was rejected by the Tax Court in *William J. Hirsch,* 4 T.C.M. 4 (1945). It was revived in *Claire L. Canfield,* 7 T.C. 135, reconsidered 7 T.C. 944 (1946), reversed *Canfield* v. *Commissioner,* (6th Cir. 1948) 168 F. 2d 907, 36 AFTR 1140; and again applied in *W. B. Woolsey,* 5 T.C.M. 1038 (1946), reversed (6th Cir. 1948) 168 F. 2d 330, 36 AFTR 1043; *L. B. Hartz,* 6 T.C.M. 465 (1947) reversed (8th Cir. 1948) 170 F. 2d 313, 37 AFTR 356, cert. den. 337 U.S. 959 (1949); *David L. Jennings,* 10 T.C. 505 (1948). During this period the Treasury Department issued I.T. 3845, 1947-1 C.B. 66 providing for allocation in family

To what interest is it applicable? "In the case of any partnership interest created by gift" the section applies. And for its purposes an interest purchased by one member of a family from another is considered a gift from the seller. "Family," in this sense, embraces not only spouses, lineal descendants and ancestors, but trusts for the benefit of these persons. It does not, however, include brothers or sisters.[59]

Reallocation in the personal service partnership. An interest in a personal service concern may well be recognized when granted in return for vital services. In such case the courts most likely will classify the interest as non-capital. Will the allocation provision apply to it? In its language the allocation provision is broader than the definitional section. For while the definitional section employs the term "capital interest," the allocation section pertains to "any partnership interest," thus embracing the non-capital interest, as well. If the courts hold that a conveyance for vital services is a "purchase," then when transacted between family members, the conveyance is deemed a "gift" under the section and the allocation provision should logically apply.

Allocation technique. In enacting Section 191 of the 1951 Act, Congress probably intended that the partners be taxed on their distributive shares only after a reasonable salary had been added to the donor's taxable share for his services and the remainder of the income had been divided among both partners according to their capital holdings. However, by failing to pinpoint its desire, Congress has left the way open for both Commissioner and taxpayer to champion different interpretations.

Commissioner's contention. The Commissioner may contend that "reasonable compensation for services rendered . . . by the donor" requires something other than mere allocation of a reasonable salary to the donor. It requires that the donor be allocated *that proportion of the business profits* attributable to his services. This argument could be based in part on a comparison of Section 191 with Section 23(a)(1) of the 1939 Code.[60] In Section 23, Congress authorized the deduction from gross income of a "reasonable allowance" for corporate officer's salaries. The courts read "reasonable allowance" to mean the value of the services on the open market. And they determined this by considereding salaries attached to like positions in similarly situated concerns.[61] Since Congress used different language in Section 191, the Commissioner could claim that it meant to establish a different rule for measuring compensation. What is this rule? It is the one used in the early *Canfield* case and recommended by the Bureau before the 1951 Act.[62] The

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partnership cases. As noted, *Canfield*, *Woolsey* and *Hartz* were reversed on appeal. The *Culbertson* opinion expressly left the issue open, and on the day it was handed down, the Supreme Court denied certiorari in *Hartz*. See, Prentice-Hall Federal Tax Service, 1955, Vol. 2, Par. 15,522.

[59] Although reallocation will not be made in partnerships created by purchase among non-family members (as "family" is defined by the Code) if the purchase is found to be essentially a gift, the allocation provision will apply. This may affect unconvincing sales to collaterals called gifts by the courts. Reg. 118, § 39.191-2(b)(2).

[60] 1954 IRC § 162(a)(1); 1939 IRC § 23(a)(1)(A). For much of the following analysis, the author is indebted to Comment, *op. cit.*, footnote 3, above, pages 550-554.

[61] See, e.g., *Faucette Co. Inc.*, 17 T.C. 187, 196 (1951).

[62] G.C.M. 9825, X-2 C.B. 146 (1931) originally announced this method of reallocating income for one aspect of the earned income credit provision; that is, in community property cases to separate the income earned by the husband's services from that earned by his capital

formula calls for an apportionment of profits between income attributable to personal services and income attributable to capital. To illustrate: assume that a partnership in which the donor performed all services earned $100,000 during the tax year, and that under Section 23 criteria, $36,000 would be a reasonable salary and $24,000 would be a fair return on invested capital. The Commissioner would allocate 24/60 of $100,000 or $40,000 to capital and 36/60 of $100,000 or $60,000 to services. If the donor and donee had equal shares of invested capital, the donee would be taxed on half the income allocated to capital—$20,000, and the donor would pay taxes on the other half attributed to capital plus the full amount attributed to services or $80,000 in all.[63]

The Treasury Regulations dealing with this section do not specifically preclude the Commissioner from taking this approach although they do seem to suggest the one discussed below under the heading "resolution." They announce that in determining a reasonable allowance for services rendered by the partners, consideration will be given to all the circumstances of the business, including the fact that some of the partners may have greater managerial responsibility than others. Among other factors there will be considered the amount that ordinarily would be paid in order to obtain comparable services from a person not having a capital interest in the business.[64]

Taxpayer's argument. On his part the taxpayer will contend that nothing in the legislative history shows that Congress meant to distinguish between "reasonable salary" and "reasonable compensation." Partnership income, he will point out, can not sensibly be divided into that portion earned by services and that portion earned by capital.[65] Profit is the residue of income after the capital and services—whether the owner's or another's—are compensated. It results from the fact that the partnership is a going enterprise with a reputation and good will that has developed over its years of operation. And it is thus compensation to the owners of the enterprise not for capital or services but for bearing the continuous risks of operation. In fact, pressing his cause, the taxpayer may argue that profits must be taxed according to their distribution under the partnership agreement. For they are not products of capital or services, and the act provides only for allocation of those products. Following this theory in the case assumed above, the $40,000 not directly attributable to capital and services could be added to the donee's $12,000 return on capital, making his taxable income $52,000. The donor would pay taxes only on $48,000.

Resolution. In executing the allocation provision the courts will probably avoid the brambles posed by both contentions. It was Congress' aim that the Com-

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where the husband is a member of a partnership. In 1947, the Treasury indicated that it approved this same method as the proper allocation technique for family partnerships. I.T. 3845, 1947-1 C.B. 66, 68.

[63] This example is borrowed from G.C.M. 9825, footnote 62, above.

[64] Reg. 118, § 39.191-2(a)(3).

[65] Attempts to compute the percentage of profits earned by services are frustrated by lack of external standards on which to base the computation. See discussion in Robinson, *op. cit.*, footnote 33, above. And to grant capital a fair return and apportion the rest of the income to services has no basis in economic reality. Robinson demonstrates that either (a) starting with an allocation to services or (b) granting capital a fair return and attributing the remainder of income to services, leads to unexpected results. Though the services performed are constant, their value fluctuates from "astronomical figures to a minus quantity."

missioner determine the fair value of the donor's services rather than the percentage of profits they earned. And this approach is strongly suggested by the pertinent Treasury Regulation. It coincides with the taxpayer's basic proposition that profit is residue after compensation of services and capital. Congress did not intend, however, that the partners distribute according to their own desires profits not attributable directly either to capital or services. By permitting the Commissioner to reallocate income in proportion to capital accounts after compensating the donor's services, Congress has employed a shorthand method of both compensating capital with interest and dividing profits according to risk of loss. For, generally, the partners will share losses in proportion to their capital accounts. Following this technique in the case assumed above, the donor will be taxed on the value of his services, or $36,000, plus his share of the remainder—$32,000. The donee would be taxed only on his share of the remainder or $32,000.

While this interpretation of the allocation provision fits well when applied to non-limited partnerships, in the limited partnership arrangement the partners do not share losses in exact proportion to their capital accounts. The Treasury regulations therefore require that consideration be given in the allocation of income to the different proportion of credit risk assumed by the partners.[66] The complexity of such a computation, however, makes it difficult to estimate in any case how much effect the different proportion of credit risk should have. Actually, the fact that the limited partner does not bear as great a risk of loss permits no additional surtax savings to the donor. It seems doubtful, therefore, that the proportion of credit risk will have or should have any significant effect on allocation.

A different problem that might be posed under the Code arises when the donee too makes a contribution of services to the business and when the business does not earn enough to cover both donor and donee salaries. This situation is very likely in the earlier years of a business. Thus, assume that the fair value of the donor's services is $25,000 and the donee's $10,000, and that the business nets only $25,000. Although the donee may, in fact, be paid part of the income for his services, the Commissioner may claim that exact reading of the Code requires that the donor be taxed on all of the $25,000.[67] The donor will contend that realistic appraisal of the situation requires recognition of the donee's services as well. Quite possibly, in such case, the courts will construe the words "reasonable compensation" to permit some distribution of income to the donee for tax purposes. This can be done by making one criterion of reasonableness the relation of salaries to the business profits as well as to the salaries of similarly situated managers.

Another difficulty may arise from the language of the allocation provision when there are partners in the business in addition to the donor and donee. For the statute fails specifically to tax to the donor income not includible in the donee's distributive share because it is fair compensation for the donor's services, or because it is a proportionately greater share of income attributable to the donee's capital than to the donor's. Since that income is neither included in the donee's distributive share nor specifically taxed to the donor, under the statutory wording it would seem to revert to the status of partnership income and be divided for tax purposes among all the partners except the donee. This would permit the donor to split his income almost to the same extent as he did before the allocation provision. And what is worse, it would burden his unhappy partners with a tax on income they never received. The sensible solution, and one certain to prevail, is that having ascertained the fair value of the donor's services and the proportionate return on his capital the courts tax that amount to the donor under the *Lucas* v. *Earl* and *Clifford-Horst* doctrines.

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[66] Reg. 118, § 39.191-2(b)(3).

[67] Even the Treasury Regulation leaves this possibility open. It provides that "the partnership income of the donor and donee shall be reallocated by making a reasonable allowance for the services of the donor and by attributing the balance of such income (*other than a reasonable allowance for the services, if any, rendered by the donee*) to the partnership capital of donor and donee." (Emphasis added.) Reg. 118, § 39.191-2(a)(2). This permits compensation to the donee only *after* the donor's services are compensated. While it treats the situation where the partnership income more than covers the donor's allowance for services, it does not answer the question here presented where the partnership income barely covers or fails to cover the donor's allowance.

A simple move may save prospective donors from tripping over the allocation provision. They should provide in the partnership agreement for a reasonable salary to be paid them. In most cases this will eliminate wrangling with the Commissioner. And if a case should come before the courts, a salary history would probably be accorded great weight in judging the reasonableness of the compensation.

Donor. It would be consonant with Congressional aims that reallocation be made to compensate any *partner* for his services. Instead, the Code requires reallocation of income only to compensate the *donor*. And it defines the donor as one who makes a gift of a partnership interest, or one who sells it to a family member. By properly arranging his transactions the enterprising taxpayer may attempt to escape the allocation provision through the loopholes in the term donor. Thus, a father may give a partnership interest to his wife, and she in turn may pass it on to their son. The son is the donee. But the mother rather than the father is the nominal donor. Must the father's services be compensated? In the same vein the father may sell his interest to a non-family member and give his son the funds to repurchase it from the seller at a small profit to the vendor or he may give his son the funds to buy out an existing partner. Can the father be identified as a donor? Strictly viewed these situations do not fall within the compass of the allocation provision. However, the Treasury Regulations call for judicial telescoping of the transactions to find the real party making the transfer.[68] And probably the courts will find the statutory language flexible enough to reach these attempts.

Existing husband-wife partnerships established before the 1948 Revenue Act income splitting provisions offer the safest vehicle for attempting these manipulations. The partner-wife can now give her share to her child. Where the wife invested her own capital in the original partnership, the husband was never a donor and reallocation of the partnership income would be inappropriate under the Code.

8. The Family Corporation vs. the Family Partnership

The 1951 Act may make it advisable for family corporations to turn in their corporate coats for partnership issue.[69] The partnership now will be recognized for tax purposes. And since it is unlikely that the courts will delve into the history of the corporation to find a donor, the allocation provision is probably ruled out. In many family corporations, moreover, the Commissioner has succeeded in fixing the officers' salaries at a low figure to increase the corporate profits figure for tax purposes. So that even if the courts do unearth a "donor," the low salary figure established for the donor when the business was incorporated may be controlling now that the donor is a partner. In short, then, there are no longer the same tax advantages to be gained by incorporation and there is the disadvantage of generally higher corporate taxes.

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[68] Reg. 118, § 39.191-2(b)(1).

[69] See, McLain, "Family Partnership v. Corporation," *Vanderbilt Law Review*, Feb. 1949, Vol. 2, pages 231-240 for a look at this issue before the 1951 Act.

9. The Donee in Military Service

"The distributive share of a partner," the section declares, "shall not be diminished because of absence due to military service." Under the Code the distributive share of a donee-partner is to be diminished only when his capital is earning proportionately less than the donor's, or when the donor is not fairly compensated for his services. Since entrance into the military service by itself would not affect the capital account, the provision construed consistently with the rest of the section must mean this: where, *because* the donee has entered military service, the donor is performing more services for the partnership, the distributive share of the donee will not be reduced by the value of those *added* services.

This provision can lead to no difficulty if the donee's share under the partnership agreement is not changed. It would seem to compel an unfair result where the donee's share is reduced pursuant to the partnership agreement because he is temporarily inactive in the business. Since his distributive share for tax purposes may not be reduced, the donee may now be taxed on income he never receives.[70] Apparently, though, this conclusion will not be demanded by the Commissioner. The Treasury Regulation advises that the partners may by agreement allocate a smaller share to the absent partner due to his absence.[71]

10. The Law Governing Pre-1951 Returns

The 1951 Act declares that "the amendments made by this section shall be applicable with respect to taxable years beginning after December 31, 1950." It thus immediately raises the question whether partnerships will be recognized and income allocated for the tax years preceding 1951. As far as partnership recognition is concerned, this provision sends the courts back to the *Culbertson* decision. This means that the courts probably will not recognize capital interests in what they deem a personal service business. Culbertson, of course, dealt with a non-personal service business. But though it drew no specific distinction between personal service businesses and those where capital is significant, neither did it preclude the lower courts from applying the pre-*Tower* rule regarding personal service businesses.

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[70] This particular provision might even injure non-family partners. The provision reads, "The distributive share of a partner," and does not specify that it must be a family partner, nor contain limiting language like the words "for purposes of this section," contained in the very next sentence. One factor mitigating against its application to all partners is the heading of the allocation section—viz. Family Partnerships.

[71] Reg. 118, § 39.191-2(a)(4).

As for non-personal service business, a good guide is the Treasury's recent declaration of intention.[72] Where an interest is based on a purchase or loan the Treasury may put in issue the validity of the purchase or loan. The transfer will be deemed bona fide where it has the usual characteristics of an arm's length transaction. It must be a real obligation enforceable against the purchaser or borrower regardless of the success of the venture. And the purchaser or borrower must have had sufficient funds to meet his obligation independent of the partnership earnings. The Treasury does not read *Culbertson* to require a business purpose for the transfer. As long as the capital is not obviously unnecessary the purchase will be upheld.

Where the partnership interest is transferred by gift, the Treasury under the *Culbertson* decision will recognize the donee as a partner so long as the gift is complete. Of course, this is the same standard as the 1951 Act's and tests of completeness will be the same as those discussed above in relation to post-1951 returns. Similarly, trust's and children's interests will be recognized under the conditions outlined above.

Will allocation be attempted for the pre-1951 returns? The early tax court reversals on the allocation principle have not deterred the Service from trying again.[73] In its mimeograph the Service makes it clear that it will ask for reallocation where necessary.[74] If it succeeds, the techniques established under the 1951 Act will undoubtedly be the ones applied to pre-1951 returns.[75]

Apparently, the allocation provision applies to partnerships formed before December 31, 1950 for taxable years beginning after that date. The question may arise whether a partnership interest purchased from a family member before 1951 is to be treated for the taxable years after 1951 as having been acquired by gift, so that the partnership income will be subject to reallocation under the Code. Very likely, if the purchase was merely a disguised gift, such as a purchase made with funds loaned or donated by the seller, it will be treated as a gift for purposes of post-1951 reallocation. If the purchase was legitimate, however, allocation would not seem indicated by the 1951 Act. Of course, even where the purchase was legitimate, if the division of profits is unrealistic, allocation may be sustained by the courts outside the auspices of the 1951 Act on the same theory that would allow allocation in pre-1951 returns.

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[72] Int. Rev. Bu. Mimeograph 6767, 1952-1 C.B. 111. Reg. 118, § 39.191-1, although pertaining directly to the 1951 Act, illustrates the kind of restraint the Commissioner will attack in pre-1951 returns.

[73] See footnote 58, above; *Weiss* v. *Johnson* (2 Cir. 1952) 206 F. 2d 350, (affirming jury verdict for reallocation of capital earnings); *Porbeck* v. *Self* (D.C. Ark., 1953) Prentice-Hall Federal Tax Service 1953, Vol. 4, par. 72,406 (Jury decision against Commissioner). Cf. *Alexander* v. *Commissioner* (5th Cir. 1952) 194 F. 2d 921, 926, 41 AFTR 872, 877; *Thomas H. Brodhead,* 18 T.C. 726, 735 (1952).

[74] *Op. cit.,* footnote 72, above, at page 120.

[75] The 1951 Act specifically stated that no inferences were to be drawn from it with respect to the taxable years before 1951. However, if the courts conclude in their own right to allocate income, the techniques naturally will be those evolved under the Act.

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How to Handle Charitable Contributions

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2. Deductions Under the Tax Law

Deductions for charitable contributions have long been permitted by the tax laws.[1] Notwithstanding, there still are numerous taxpayers who are unaware of the many facets of the deductions for charitable gifts. Too often a taxpayer makes contributions without any consideration of tax aspects, only to learn subsequently that proper handling might have resulted in a larger gift to the charity at a lesser net cost to him.

The tax laws favor charitable gifts.[2] When it is observed that, within limitations, taxpayers reduce their income subject to tax by the amount of their contributions to charitable organizations it becomes plain that, to a certain extent, the Federal Government is subsidizing such organizations. The size of the potential amount thus removed from taxation might be gathered from a reference to approximate annual income figures for corporations and for individuals:[3]

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[1] When the deduction from income for charitable contributions was first advanced in the 1917 Act, the amount of the proposed deduction was 20 per cent. See Report of Senate Hearings as included in Seidman's *Legislative History of Federal Income Tax Law*, pp. 944-945. The deduction approved by Congress was arbitrarily reduced to 15 per cent. Section 102(c) of the Revenue Act of 1935 provided for corporate deduction of contributions. Prior to that time contributions were deductible by corporations only if qualifying as ordinary and necessary business expenses under IRC § 23(a). Also see No. 2 below.

[2] See *Helvering* v. *Bliss*, 293 U.S. 144, 14 AFTR 668 (1934).

Corporate income before taxes	$39.7 billion
Personal income before taxes	$268. billion

If the maximum contributions of 5 per cent for corporations and 20 per cent for individuals were made, the total income that the Federal Government is willing to release from taxation, so that it may be available for private philanthropy, would approximate $55 billion.

The present discussion is not primarily concerned with estate planning,[4] although certain aspects of the discussion will be equally applicable to that phase of charitable giving. Nor are we here concerned with tax exempt organizations[5] or controlled charities and foundations.[6] Instead, consideration will be given in this presentation to methods of giving property, the nature of the property to be transferred, and the timing of the gift.

A distinction should always be drawn between charitable contributions, and expenditures in the nature of contributions that may be deductible as ordinary and necessary business expenses.[7] Advertising in a veteran's organization yearbook,[8] supporting a religious institution when in the business of selling religious products,[9] sponsoring welfare activities in order to build employee good-will,[10] or contributing to the Lions Club to provide food for needy families,[11] are legitimate business activities the costs of which are deductible as necessary business expense, and need not be treated as charitable gifts.

Limitations on deductions. Initially, certain fundamentals of this subject should be stated in order that there be a common understanding of the problems. The Code, though encouraging gifts to charities, limits the deduction for contributions in terms of the taxpayer's income. Individual deductions were restricted to 20 per cent of the adjusted gross income under the 1939 IRC.[12] The 1954 IRC allows a deduction of 20 per cent of adjusted gross income. An additional deduction of 10 per cent of adjusted gross income is allowed for the aggregate of contributions made to specified organizations.[13] The additional 10 per cent deduction is not allowed if the gifts are made in trust.[14] If the individual contributes more than 10 per cent of his adjusted gross income to the organizations specified, such excess contributions shall be taken into account for the purpose of computing the general limitation of 20 per cent.[15] The deduction is allowable only if the contribution is actually paid.[16] Husband and wife take 20 per cent of their combined adjusted gross income, regardless of which spouse made the contributions. The full amount of all charitable contributions is deductible from income where 90 per cent of the taxpayer's income for eight of the past ten years was paid in contributions and taxes.[17] Corporate gifts to charity are limited to 5 per cent of the corporation's net income, computed without regard to the contributions deduction or the net operating loss carryback.[18] Where the corporation makes contributions in excess of the 5 per cent limitation, section 170 provides that such excess shall be deductible in each of the two succeeding years, but only to the extent of the lesser of the two following amounts, (1) the excess of the maximum amount deductible for the succeeding year over the contributions in that year, and (2) in the case of the first succeeding year the amount of the excess contribution, and in the case of the second succeeding year, the portion of such excess contribution not deductible in the first year. A contribution by an accrual basis corporation will be deemed to have been paid in the taxable year, if payment is actually made within two months and 15 days following the close of the taxable year, provided such corporation so elects and its board of directors authorized such contribution.[19] The Tax Court held that payment by check in the latter part of the year entitled the taxpayer to a deduction, even though the check did not clear the bank until the subsequent year and the taxpayer could have stopped payment thereon any time prior to its clearance.[20] Moreover, a corporation taxpayer was allowed to take the deduction upon its payment of pledges, made by two stockholders and signed in their individual names, where they acted on its behalf.[21]

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[3] Figures taken from *Survey of Current Business,* U.S. Department of Commerce.

[4] For an integration of charitable contributions with estate planning see Edward N. Polisher, *Estate Planning and Estate Tax Saving,* second edition, Philadelphia. George T. Bisel Company, 1948, and 1953 Supplement thereto.

[5] See the Chapter in this book entitled, "*How to Organize and Operate a Tax Exempt Company.*"

[6] See the Chapter in this book entitled, "*How to Use Charitable Trusts and Foundations.*"

[7] Ordinary and necessary business expenses are deductible under 1954 IRC § 162(a); 1939 IRC § 23(a), and charitable gifts are deductible under 1954 IRC § 170; 1939 IRC § 23(o). Reg. 118, § 39.23(a)-13 states: Donations to organizations other than those described in Section 23(q) [1954 IRC § 170] which bear a direct relationship to the corporation business and are made with a reasonable expectation of a financial return commensurate with the amount of the donation may constitute allowable deductions as business expenses." The rule was previously applied only in the case of corporations, but under the 1954 IRC Section 162, the application has been extended to individuals. See also Reg. 118, Section 39.23(q)-1 dealing with "corporate contributions." See also, the chapter in this book entitled "How a Business Can Get Maximum Deductions for Contributions."

[8] *Alexander Sprunt & Son, Inc.* 24 B.T.A. 599 (1931) (acq. XI-1 C.B. 6).

[9] *The B. Manischewitz Company,* 10 T.C. 1139 (1948).

[10] *Terminal Railroad Association of St. Louis,* 17 B.T.A. 1135 (1929).

[11] *Limerick,* 9 T.C.M. 465.

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[12] 1954 IRC § 170(b)(1); 1939 IRC § 23(o). The 20 per cent deduction was inserted by Section 4(a) of 1951 Revenue Act, effective for taxable years after December 31, 1951. In prior years, the maximum deduction allowed was 15 per cent.

[13] 1954 IRC § 170(b)(1).

[14] 1954 IRC § 170(b)(1)(A). However, an individual who pledges 30 per cent of his adjusted gross income to a fund-raising foundation may be entitled to a deduction for the entire amount. But this will be possible only if a separate check is made out to a specific organization to which the "extra" 10 per cent deduction is applicable (a church, school, or hospital as defined by Section 170(b)(1)(A)). Moreover, the fund-raising foundation must provide for satisfaction of pledges by means of separate checks and must transfer the separate checks unconditionally to the payees. Otherwise deduction will be subject to the general 20 per cent-of-adjusted-gross-income limitation. This is an interesting interpretation since the new 10 per cent provision, unlike the 20 per cent deduction, does not apply to deductions "for the use of" the enumerated organizations. Rev. Rul. 55-1. IRB 1955-1.

[15] 1954 IRC § 170(b)(1)(B).

[16] Reg. 118, § 39.23(o)-1.

[17] 1954 IRC § 170(b)(1)(C). Under the 1939 IRC § 120, the income had to be paid for contributions and taxes in each of the prior ten years in order for the taxpayer to obtain the deduction.

[18] 1954 IRC § 170(b)(2); 1939 IRC § 23(q). Prior to the enactment of the 1954 Code, the corporation's income was reduced by the amount of the net operating loss carryback before the charitable deduction was computed. Rev. Rul. 287 (1953-26); Rev. Rul. 54-56 IRB 1954-7.

[19] 1954 IRC § 170(a)(2); 1939 IRC § 23(q). Section 3, H.R. 5268, 81st Congress, 1st Session, approved by the President, October 25, 1949. This amendment is retroactive to all years beginning after December 31, 1942. Additional amendments made by this Section will permit the computation of Section 102 net income (1954 IRC §§ 531-537), Supplement P net income (1954 IRC §§ 551-557), and Subchapter A net income as paid within the taxable year of any such contribution, if actually paid within two months and 15 days after the end of the corporation's taxable year.

For the deduction to be available, a gift in cash or property must be actually made.[22] Merely permitting a charitable organization the tax-free use of property will not support a deduction as a contribution for the value or the rental value of the property.[23]

There is no limitation for tax purposes upon the charitable deduction from income of estates and trusts.[24] Moreover, with such taxpayers, the amount need not actually be paid in the period in which deduction is claimed. The Code authorizes deduction for the amount that "pursuant to the terms of the governing instrument is, during the taxable year, paid or permanently set aside for a purpose specified in section 170(c). . . ." [25] However, such a trust may lose its unlimited deduction, if it engages in certain prohibited transactions, as defined in 1954 IRC section

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[20] *Modie J. Spiegel Estate,* 12 T.C. 524 (1949); Acq. 1949-2 C.B. 3. The checks were drawn on December 30, 1942, and did not clear the bank until the middle of January, 1943. The court held that in normal commercial usage the mailing of a check is "payment" of the amount. Therefore "payment" was made in 1942.

[21] *The G and R Corporation* (1949) par. 49,263 Prentice-Hall Memorandum T.C.

[22] In Rev. Rul. 162, 1953-18, the fair market value of blood made to a charity was held not to be deductible under Section 23(o) on the ground that blood is not property but constitutes rendering a service. On the other hand, a taxpayer who gives his services gratuitously to a charitable organization may deduct as a contribution the cost of unreimbursed traveling expenses, including meals and lodging, while away from home in connection with the organization's affairs. Rev. Rul. 55-4, IRB 1955-1. In *Hugh H. C. Weed,* par. 72,631 Prentice-Hall Fed. (1954 D.C. Mo.), the taxpayer organized a corporation in order to acquire a business. The profits from the business were to be distributed to Amherst College. The taxpayer made a contribution to the corporation and deducted it from his income as a charitable contribution. The Court held that the contribution was deductible. It was made "for the use of" a charity. This interpretation appears to be doubtful in light of Rev. Rul. 194, 1953-20, where it was said that the word, "for the use of" is synonymous with the term "in trust for." Note that the 1954 IRC in Section 170(c) also uses the term "for the use of."

[23] I.T. 3918, 1948-2 C.B. 33. Consider, also in this connection, the decision that permitting a rent-free use by a charity does not appropriate the property to a business purpose. *Emmet,* 11 T.C. 90 (1948). On the other hand, where the taxpayer made a deed to a charity for a determinable period, a deduction was allowed in the year the deed was executed, for the value of the determinable fee conveyed to the charity. *Priscilla M. Sullivan,* 16 T.C. 228 (1951); Acq. 1951-1 C.B. 3. See also discussion under "Income to charity, remainder to individual beneficiary," Section 3 of this Article.

[24] 1954 IRC § 642(c); 1939 IRC § 162(a). For a full discussion of trust for charitable purposes, see Lloyd W. Kennedy, *Federal Income Taxation of Trusts and Estates,* chapter 3. Boston: Little, Brown and Company, 1948.

[25] 1954 IRC § 642(c); 1939 IRC § 162(a). In *Arthur Jordan Foundation* v. *Comm.* (7 Cir. 1954) 210 F. 2d 885, the question involved the interpretation of the phrase "permanently set aside." The facts were that a trust instrument provided that when the corpus of the trust reached five million dollars all of the income was to be paid to charity. Until that time, not more than half of the income was to be distributed. The other half was to be added to corpus. The accumulated funds would never actually be distributed, but would be used to produce more income for charity. In the taxable year in question, as the corpus was well below five million dollars, the trustee distributed part of the income and accumulated the rest. He deducted the full amount of the income from his adjusted gross income. The Tax Court held that he could only deduct the amount actually distributed. The Seventh Circuit held that the full amount was deductible because all of it was "permanently set aside" for charity, even though the charity would never receive any of the accumulated funds.

681(b)(2);[26] and will be limited to 10 per cent[27] of the net income of the trust, as provided in section 681(b)(1).[28]

Where the contribution is made in money, there is no problem in determining whether the limit has been observed or exceeded. However, many gifts are made in the form of property. In such cases, the deduction is for its value at the time of the transfer.[29] The valuation of property may frequently pose difficult problems. In this connection, reference should be made to the estate and gift tax Regulations.[30]

3. How to Donate Property

The actual method of making a gift to a charity deserves the careful consideration of a taxpayer. He is always confronted with the problem of obtaining the maximum tax benefit for himself; at the same time, he is mindful of the particular needs of the organization. The method chosen by a taxpayer can promote or impair accomplishments of these objectives. In the following two cases the taxpayer lost the deduction through faulty draftsmanship. In *Delaney* v. *Gardner*,[31] the testatrix left money to her executors to dispose of it in their discretion, but giving weight to a memorandum left by her. The memorandum consisted of the names of charities with the amount the testatrix wished each to have opposite each name. The issue was whether the amounts given to the charities by the executors were deductible as a "bequest, legacy, devise, or transfer" within the meaning of section 812(d).[32] The court held that the amounts were not deductible as the section only applied to "those gifts which pass by the terms of a testamentary instrument."

In *Carro May Audigier*,[33] a husband gave his property to a university, reserving a life estate. He later married the taxpayer. The university leased the property to X, and at the request of the husband, X promised to pay the taxpayer a monthly income if she outlived her husband. It was held that the payments made by X to the taxpayer were taxable income and not gifts. There was consideration for the payments and the taxpayer could not prove the requisite donative intent in order to establish a gift.

Outright gift. An outright gift requires little discussion, since the consequences are well known. The donor is permitted a deduction for its value at the time of the transfer. The charitable organization obtains an immediate benefit inasmuch as it owns the property as soon as the gift is completed. Though this is the most common form of gift, it is not a "must" so far as giving is concerned. Other methods should be examined to determine whether there is another way of giving that will produce more desirable results.

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[26] 1939 IRC § 162(g)(2)(B).

[27] 1954 IRC § 681(b)(1).

[28] 1939 IRC § 162(g)(2)(A).

[29] Reg. 118, § 39.23(o)-1(g).

[30] Reg. 105, § 81.10. Note particularly the valuation of interests at sub-section (1). See also Reg. 108, § 86.19.

[31] (1 Cir. 1953), 204 F. 2d 855. Although this case and the *Audigier* case do not deal entirely with the issue of the method a taxpayer should employ to make a charitable gift, they do illustrate the principle that a taxpayer should not make a substantial contribution without first considering the tax ramifications carefully.

[32] 1954 IRC § 2055.

[33] 21 T.C. #75 (1954). The taxpayer won a close decision in *Elmira Bank and Trust Co.* v. *McGowan* (D.C.N.Y. 1954), par 132, 735 Prentice-Hall Estate and Gift Tax Service, where testator made gifts to an organization before the organization was incorporated. The gifts were held to be deductible from the gross estate under Section 812(d) on the ground that the money could only be used for charitable (educational) purposes.

Life income to individual beneficiary, remainder to charity. If a donor wishes to provide for certain specific individuals during their lifetimes, but at the same time desires to make a present gift to a charity, he can do so by creating for the charity a remainder interest in the cash or property to be given. If this is done, the value of the remainder interest, determined by reference to mortality tables and assumed interest rates, will be deductible at the time of the gift.[34] This form of gift has the advantage of permitting the taxpayer to make satisfactory provision for the individual objects of his concern, while assuring ultimate transfer of the property to the charity. From the point of view of the charity, it is advantageous, inasmuch as it is assured that it will ultimately own the entire property outright, and can therefore plan accordingly.

In order to meet a particular circumstance, the interest preceding that of the remainder given to charity may be a term for years, a term for the life of the beneficiary, or for the life of the survivor of two or more named individuals, or for a term which will end upon the happening of a particular event. None of these changes will affect the charity's right to receive the entire property eventually.[34a] Consequently, the donor's right to the deduction will not be affected. The problem of valuation may be made more difficult but this should not discourage the donor from making the gift.

Invasion of principal for life beneficiary. A donor may find that the provision for a life income only to the beneficiary, with remainder over to charity, is quite sufficient for all his purposes. However, he may be concerned whether the income alone will be adequate for the needs of the life tenant. Income yields on property are not guaranteed. A conservative and provident donor might well wish to provide for all contingencies, including the possible situation where the income proves to be inadequate for the life tenant. The logical manner in which to safeguard against this contingency is to provide for consumption of the principal of a trust, should the income be insufficient.

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[34] *Ithaca Trust Company* v. *United States,* 279 U.S. 151, 7 AFTR 8856 (1929); Reg. 105, § 81.44. See Reg. 105, § 81.10(i) for valuation tables and method for determining value of remainder interests. In *McFarland* v. *Campbell,* (5 Cir. 1954), par 132,727 Prentice-Hall Estate and Gift Tax Service, a surviving spouse in a community state was not permitted to include her interest of the community property in the husband's gross estate for the purpose of computing the charitable deduction, even though the two had executed a joint will. Her interest had not passed to the charity under local law. In Rev. Rul. 145, 1953-16, an estate was only allowed to deduct the amount actually paid to a charity under a compromise agreement. It could not deduct what it would have had to pay to the charity if the charity had won the lawsuit.

[34a] An estate tax deduction for a charitable bequest was not allowed where it was to take effect only if the decedent's childless 27 year old daughter died without decedent's surviving her and her mother, 62 years of age. The Court found no statutory authority in Section 812(d) of the 1939 Code for the deduction from a gross estate of any percentage of a conditional bequest to charity, where there was no positive assurance that charity will receive the bequest or some determinable part of it. *Commissioner* v. *Estate of Louis Sternberger* 348 U.S. 187 (1955).

A provision for invasion of the corpus of a trust for the benefit of a life tenant creates the possibility that the corpus may not pass intact to the charity-remainderman. If, in the light of all relevant circumstances, the probability of invasion of the corpus is slight and, in all likelihood, the principal of the trust will pass intact to the charity, the deduction for the gift of the remainder will not be affected. The estate tax Regulations deal with the problem when it results from a testamentary disposition. They state that the deduction will be permitted, if the possibility of diversion from the charitable purpose is "so remote as to be negligible." [35] Many decisions by the courts have been concerned with this issue, which has always revolved about the interpretation of the language employed in the instruments involved. These decisions are most helpful in indicating the attitude of the courts. A provision that restricted invasion of the corpus to those sums that "may be necessary to suitably maintain her in as much comfort as she now enjoys" was deemed to be a sufficiently clear standard to enable the court to ascertain the amount of principal that would ultimately go to charity.[36] On the other hand, where the beneficiary was a ninety-three year old woman, who was authorized to use as much of the principal as she "may at any time and from time to time need or desire," the remainder passing to the charity was considered to be so indefinite as to cause the deduction to be denied.[37] In 1943, the Supreme Court held that the word "happiness" made an otherwise definite standard sufficiently vague as to render the charitable remainder unascertainable.[38] In a recent Circuit Court decision[39] the trustee was authorized to invade the corpus for the

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[35] Reg. 105, § 81.46.

[36] *Ithaca Trust Company* v. *United States,* footnote 34, above.

[37] *Gammons* v. *Hassett,* (1 Cir. 1941), 121 F. 2d 229, 27 AFTR 663, cert. den. 314 U.S. 673.

[38] *Merchants National Bank of Boston, Exec.* v. *Comm.,* 320 U.S. 256, 31 AFTR 753 (1943), noted in *University of Pennsylvania Law Review,* 1944 Vol. 92, page 325.

[39] *Blodget* v. *Delaney* (1 Cir. 1953), 201 F. 2d 589, 43 AFTR 198. Rev. Rul. 54-285, IRB #29, July 19, 1954, sets forth the two-fold test for determining whether an estate is entitled to a charitable deduction where there is a power to invade corpus for the benefit of the life tenant. (1) Is there an ascertainable standard set forth so that the amount which will eventually go to charity is ascertainable; (2) is the probability of invasion remote. In the same ruling it was held that an invasion for the "comfort, support, hospital or medical expenses" of the life beneficiary was an ascertainable standard where the life beneficiary was 79 and had an independent income more than enough to care for her needs. In *Lincoln Rochester Trust Co.* v. *McGowan* (DC N.Y. 1953), 109 F. 2d 437, the Court refused a summary judgment for the government where the direction to invade was "to meet any unusual demands, emergencies, requirements or expenses for her personal needs that may arise." In *Estate of Carlson,* 21 T.C. #34, (1953), the invasion was to maintain the life tenant "in the manner to which she is accustomed." The facts indicated that her standard of living not only was easily determined, but that in the three years since her husband had died she had increased her net worth by $6,000. It was held that the charitable deduction was allowed under Section 812(d). See also *Estate of Dorsey,* 19 T.C. 493 (1952) (standard was not ascertainable). The following cases, although not concerned with a power of invasion, shed light on the meaning of a remote interest. In *Dean* v. *United States* (D.C. Mass. 1953) para. 132, 632, P-H Estate & Gift Tax Service), the charity was to receive property only if an individual of 82 outlived two persons ages 67 and 68. The charitable deduction was allowed to the estate on the ground that the probability that the charity would not receive the property was remote. In *Sullivan* v. *United States* (D.C. Mass. 1953), 113 F. 2d 749, a will provided that if X could not be found a charity was to receive the property. Unbeknown to the testator X was dead when the will was executed. The charitable deduction was allowed to the estate because there was no possibility whatsoever that the charity would not take.

"comfort and welfare" of the life tenant. The life tenant was in her eighty's, was blind and had followed a rigid and frugal pattern of living for many years. Her needs were reasonably capable of calculation, and it was anticipated that her income would exceed her expenses. The court held that the probability of invasion was negligible and hence the estate was permitted the charitable deduction. Justice Magruder, in a concurring opinion stated that where a court must split hairs over "comfort and welfare" and "comfort, support, maintenance and/or happiness," the law should be amended. Congress, in enacting the 1954 IRC did not heed the Justice's advice.

The decisions clearly indicate that every instrument must be interpreted in the light of the circumstances surrounding it and that no universal rule can be enunciated. If the life tenant has an unbridled discretion to invade corpus, no deduction for a charitable remainder can be allowed. Since the life tenant is in a position to consume the principal without restraint, nothing definitely ascertainable would go to charity. If the instrument sets forth a specific standard that, considering all the circumstances, is interpreted to limit the amount by which the corpus might be reduced for the benefit of the life tenant, the deduction should be permitted. The circumstances, other than the language of the instrument, which must be considered include the age, health, personal wealth, and other income of the life tenant, his living habits, dependents, and so forth.[40]

Where the power to invade the corpus of a testamentary trust is given to the life beneficiary and the remainder is to pass to a charity, the life tenant may relinquish this power. The 1954 Code provides that the disclaimer by the life beneficiary of a power to consume, invade or appropriate property, before the date prescribed for filing the estate tax return, will be deemed an irrevocable disclaimer, sufficient to qualify the property for the charitable deduction, provided the remainder passes to charity.[41]

Income to charity, remainder to individual beneficiary. A donor's objective may be exactly the opposite of that discussed in the preceding section. His concern may not be for the immediate needs of particular individuals, but rather for the ultimate needs of such persons. Conversely, he may find that the present needs of the charity are pressing but that he is unwilling to commit himself to the long-range charitable demands.

These situations can be met by creating a remainder for individuals after first giving the charity an interest for a stated term or for someone's life. Thus, for example, a donor may feel that so long as he is alive, his sister will never be in need, but in the event of his death, he desires to put a particular piece of property at her disposal. A present gift of property to charity for his life with a remainder over to his sister will solve his problem.

If this form of gift is employed, the donor will be entitled to a present charitable deduction for the value of the interest given to the charity. This interest will be valued by reference to the tables set forth in the Federal gift and estate tax Regulations.[42]

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[40] See Edward N. Polisher, *op. cit.*, page 277; see also *Henslee* v. *Union Planters National Bank and Trust Company*, 335 U.S. 595, 37 AFTR 455 (1949).

[41] 1954 IRC § 2055.

[42] Reg. 105, § 81.10 and Reg. 108, § 86.19.

This device may be varied in order to meet particular needs and one possibility worth considering embraces the following:

a. A gift to charity for a term of years or for a period measured by the life of a stated individual (donor).

b. A succeeding life interest for the individual who is the object of the donor's concern (sister).

c. A remainder to the charity after the death of the object of the donor's concern (sister).

Such a disposition, as outlined above, though involving some valuation problems, does not present questions that defy answer. If the mechanism is suitable, the matter of valuation should not deter the taxpayer from employing it.

From the point of view of the charity, a gift to it of the income from property for a stated term or for the duration of an individual's life, although not as desirable as an outright gift of the entire property, is nevertheless a welcome one. The charitable organization can depend upon the receipt of the income and its budgetary requirements can be dealt with accordingly. It is true that an estate for the life of another is indefinite, in that an untimely death will cut off the income of the charity prematurely. In appropriate circumstances, a charity faced with such a problem might do well to consider insuring the life of the individual whose life measures the term of the charity's interest.

Charitable gift subject to annuity charge. An outright gift of property to a charity, subject to an annuity charge in favor of the donor or other named individuals, is a variation on the gift of a remainder interest to charity. In the case of an annuity charge, the annuitant may or may not receive the full income of the property given to the charity. To this extent, the two mechanisms are separate and distinct. Although both are designed to provide for an individual during his lifetime and to permit the charity to own the property ultimately, there are distinctions which deserve comment. Where a charitable remainder is employed, the charity has no use of the property and no benefit therefrom until the death of the life tenant.[43] An outright gift subject to an annuity permits the charity to secure full use of and benefit from the property at the time of the gift. It may retain or dispose of the property, as it wishes. Its obligation to pay the annuity may be satisfied by the charity out of the income from the property, by purchase of an equivalent annuity, or by providing for the periodic payments in its current budget. The advantage to the charity of having the immediate ownership of a property may be a substantial one. At the same time, the donor has assured himself of the income which he deemed necessary for the annuitant. For these reasons, this form of gift has become extremely popular.

The donor will be entitled to a deduction for the present value of the property, less the value of the annuity.[44] The fact that the charity has agreed to pay an annuity to a named individual (assuming that the charity is not authorized by its charter to act as an insurance company) will not affect, adversely, the right of the organization to exemption from income taxes under the 1954 IRC section 501(c)(3).[45] In a recent decision, the Sixth Circuit held that an organization will be entitled to exempt status, even though the same instrument created the exempt organization and contained the provision for the annuity.[46]

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[43] It is true that the expectancy of the charity may be discounted. Thus the charitable organization can realize a present benefit. However, expectancies are generally sold at such a large discount that the immediate benefit to the charity would be much less than the donor intended or the charity was willing to accept.

[44] See J. K. Lasser, *How Tax Laws Make Giving to Charity Easy*, Chapter VII, New York; Funk and Wagnalls Company, 1942.

Multiple gifts. If a donor has in mind the transfer to a charity of property of substantial value, he will probably be faced with the problem that an outright gift thereof in any one taxable period will exceed the maximum allowable deduction of 30 per cent of his income (or 5 per cent for a corporation). In such a case, the taxpayer should consider making the immediate use of the property available to the organization, so that the charity will enjoy the present benefits of ownership. However, in order that the gift be accomplished tax-wise, the donor should not transfer, in any one taxable period, the entire property as a single gift, but only such part whose value is of an amount, together with his other contributions, that will approximate the maximum allowable deduction for the period. This can be done in one of two ways:

a. If the property is easily divisible (such as unimproved land that is measured purely by acreage), the annual transfer may be by a stated number of units until the entire parcel is given to the charity in successive years.

b. If the property is not readily divisible, the annual gifts should be in the form of undivided fractional interests in the property.

As a result of using either of these methods, the title to the entire property will vest eventually in the charity and the donor will still have received the maximum deduction to which he was entitled.

This problem is closely related to the timing of charitable gifts, a subject to be discussed later in this article.

Advantages of trusts for gifts to charity. Earlier in this article, it was pointed out that estates and trusts are permitted an unlimited deduction for amounts paid over to or permanently set aside for charitable purposes. This unlimited deduction offers many opportunities for taxpayers to obtain maximum tax benefits for themselves and at the same time affords greater advantages to the charity.[47]

One attractive feature of employing a trust to make charitable gifts is that a trust need not make its donations to a charitable organization in order that they be deductible. For example, an individual donor who is interested in advancing the scientific research of a certain person would find that amounts that he would make available to the scientist would not entitle him to a deduction for a contribution.[48] If, however, a trust were to offer the same financial assistance, the trust would be allowed the deduction. Section 642(c) of the 1954 IRC [49] permits a deduction to the trust if its income "is to be used exclusively for religious, charitable, scientific, literary, or educational purposes."[50]

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[45] 1939 IRC § 101(6). Both Codes grant exemption to charitable organizations but specifically state that no part of the earnings shall "inure to the benefit of any private shareholder." It is now well recognized that gifts coupled with annuities do not violate this provision.

[46] *Comm.* v. *Edward Orton, Jr. Ceramic Foundation* (6 Cir. 1949), 173 F. 2d 483, 37 AFTR 1148.

[47] For a comprehensive treatment of charitable trusts see Lloyd E. Kennedy, *op. cit.* chapter 3.

[48] 1954 IRC § 170; 1939 IRC § 23(o).

[49] 1939 IRC § 162(a).

Moreover, contributions made by a trust are deductible from its income, even though the payment is made to organizations that are located outside the United States, and would not be deductible if made by individuals.[51]

An interesting question arises concerning the amount of the deduction that a trust may claim where the provision for the contribution is phrased in terms of "income." The issue is whether the term "income" is to be interpreted in a non-technical or ordinary sense, or is to be construed to mean "statutory gross income" as defined in the Code. The Supreme Court decided that it is "statutory gross income."[52]

It is therefore suggested that where there is a limitation of the percentage of trust income which is intended to be used for charity, the trust instrument should define the term "trust income," so that it will include the total of all capital gains realized by the trust in any year. This will have the effect of increasing the amount of the trust income which may be given to charity.

One mechanism for making charitable contributions that employs a trust to excellent advantage is that of the so-called "short-term" trust. This plan calls for the creation of a trust under which income will, for a stated period, be paid

Before creating the trust:		
Income	$250,000	
Charitable gifts (limited to 30%)	75,000	
Subject to tax		$175,000
Taxes on $175,000	137,916	
Contributions not deductible	25,000	162,916
Remaining after contributions & taxes		12,084
After creating the trust:		
Income $250,000 (less $40,000 that the trust has)	210,000	
Charitable gifts (limited to 30%)	63,000	
Subject to tax		147,000
Tax on $147,000		83,446
Remaining after contributions & taxes		63,554

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[50] *J. B. Whitehead Estate,* 3 T.C. 40 (1944), affirmed (5 Cir. 1945) 147 F. 2d 977, 33 AFTR 776.

[51] *Estate of Emily St. A. Tait,* 11 T.C. 731 (1948).

[52] A trust was to pay 45 per cent of its "net income" to charity, and in 1941 it had capital gains. The question was whether the allowable deduction was 45 per cent of the statutory net income, in which capital gains were considered at 50 per cent of their total or 45 per cent of the total net income. In *Comm.* v. *Central Hanover Bank and Trust Co.* (2 Cir. 1947), 163 F. 2d 208, 35 AFTR 1620, cert. den. 332 U.S. 830, the court held that the deduction was limited to 45 per cent of statutory net income. The Court of Claims, in a case involving the same trust, reached an opposite conclusion. *Helen W. Benedict, et al.* v. *U.S.,* 81 F. 2d 717, 37 AFTR 798 (Ct. of Cls., 1949), reversed, 338 U.S. 692, 38 AFTR 1208 (1950).

over or permanently set aside for charity. Upon the expiration of the stated period, the corpus of the trust reverts to the grantor. This device is especially to be recommended to a taxpayer who contemplates giving or currently gives to charity more than thirty per cent of his income and who finds that, because of the organization's needs and his personal desires, he will not be able to reduce his contributions in the near future. He determines to employ a short-term charitable trust.

His advantages may be best shown in an example:

Assume that the taxpayer, a single man with no dependents, has annual income of $250,000, before deduction for charitable gifts. He annually gives to charity the sum of $100,000. He creates a short-term trust, transferring to it property that produces an annual income of $40,000.

A consideration of the above illustration will clearly indicate the advantage to the taxpayer. He has, in both instances, given the charitable organization approximately $100,000.00. Yet in creating the trust for the purpose of turning over the trust income to charity, the taxpayer, by siphoning off $40,000 of income from his top tax bracket, is left with over $51,000.00 more in spendable income. Nor has he, to accomplish this, permanently parted with any property, since the principal will be returned to him at the end of the trust period.

The attractive features of a short-term charitable trust may be summarized as shown on page 1402.

a. The donor is entitled to a present deduction for the value of the right to the income from the property for the stated term. If, however, the donor has been exceeding his allowable contributions to charity, then, of course, this deduction is of no value to him. There can be no deduction for the value of the property as a contribution since it was never permanently given away, and will, in fact, return to the donor.

b. The problem posed by excess contributions is eliminated and a financial gain is realized by the taxpayer in that more of his income after gifts and taxes remains following the creation of the trust than before.

c. No part of the trust income is taxed to the donor during the life of the trust. It follows, of course, that no part of such income can ever be available to the donor, but all of it must find its way to charitable organizations.

d. No part of the trust income is taxed to the trustee, since all of the income of the trust is to go to charity, either currently or at the termination of the trust.

e. The donor may provide for accumulation of the trust income so that a large single gift may be made, even though the income was earned annually.

f. The principal of the trust is returned to the donor at the end of the term of the trust.

Under the so-called Clifford rule,[53] even though all of the income was paid over to proper organizations, the income was taxable to the grantor where the trust corpus would revert to the grantor before the expiration of a ten-year term.

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[53] *Helvering* v. *Clifford,* 309 U.S. 331, 23 AFTR 1077 (1940). Lengthy interpretations by the Commissioner are found in Reg. 118, § 39.22(a)-21. If the donor retains control of the property or power over trust decisions he must be careful that the *Clifford* rules on control will not operate to cause the trust income to be taxable to him.

A recent decision casts serious doubt upon the validity of this regulation as it may affect trusts for charity.[54]

The 1954 IRC, Section 673(b) provides that the income of a reversionary trust shall not be taxable to the grantor where the income is irrevocably payable for at least two years to a charitable beneficiary described in section 170(b)(1)(A). The organizations included within this section are a church, a convention or association of churches, a specified type of educational organization and a specified type of hospital.[55]

4. What Kind of Property to Give

A donor's concern with making a taxwise gift to charity extends beyond the mere determination of the nature of the interest to be transferred or the form of the transfer. One additional consideration must be "What property should be given?" Many taxpayers will decide to give cash, in which case there is no problem. However, if the donor owns several types of property, the choice of what to give is important from the point of view of tax planning.

Property that has enhanced in value. As we have observed, where property is given to charitable organization, the deduction is for the value at the time of the gift.[56] If a donor possesses property that has enhanced in value over his cost or tax basis, it will be advantageous for him to make a gift of such property in kind. By giving appreciated property, the taxpayer is in effect making a taxfree sale of the property since the appreciation in value is not reportable as income.

Assume a taxpayer is about to make a charitable gift of $10,000.00. He owns marketable securities that cost him $2,000.00 but have a fair market value of $10,000.00.

a. If he causes the securities to be sold and then makes a gift of the proceeds, he will at the end of the year be faced with payment of the tax on the $8,000.00 gain on the sale. Therefore, the entire transaction will have cost him $10,000.00 plus the tax on $8,000.00 gain. Assuming that the taxpayer employed the alternative tax computation, the gift to charity will have resulted in an out-of-pocket expenditure of $12,000.00, though the organization will have received but $10,000.00, and the taxpayer will be entitled to an income tax deduction for contributions of $10,000.00 only.

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[54] *Commissioner* v. *Clark* (7 Cir. 1953), 202 F. 2d 94, 43 AFTR 259. There the trust term was extended so that it would expire ten years after the original date of the creation of the trust, and nine years after the amendment extending the term. The only rights which the grantors had in the trust were to receive the corpus at the end of the term. The Court of Appeals held that the regulation was invalid as to the ten year provisions in that it was unreasonable, arbitrary and unconstitutional. The Court noted that the regulation set up a conclusive presumption which could not be rebutted by the facts. The Bureau has stated in Rev. Rul. 54-58 (1954) that it will follow the *Clark* case only in situations where the facts are identical, that is, (1) the trust was created prior to the promulgation of the regulation; (2) the trust was extended prior to the promulgation of the regulations so that its total term was ten years; and (3) the beneficiary is a charity.

[55] 1954 IRC § 170(b)(1)(D) limits the advantages of the section to some extent. This Section applies to transfers made after March 9, 1954. If the grantor has a reversionary interest in the corpus or income of that portion of the trust to which a deduction would otherwise be allowable and the value of the reversionary interest exceeds 5 per cent of the value of the property constituting that portion of the trust, the charitable deduction is not allowed. As an example, the Senate Finance Committee stated that where a grantor of a trust transfers $100,000 in trust to pay the income to X University for a period of 5 years and to return the corpus to the grantor or his estate at the end of such term, no deduction under section 170 is allowable with respect to the value of the income interest transferred for the benefit of X University since the value of the grantor's reversionary interest exceeds 5 per cent of the value of the property. This section does not mean that the grantor will be taxed on the income of the trust. In other words, under Section 673(b), the grantor may shift the tax burden, but he may not also deduct the trust income as a charitable contribution under Section 170(b)(1)(D).

[56] Footnote 29, above.

b. If the securities were transferred in kind to the charity the taxpayer would be entitled to a deduction for the fair market value at the time of the gift, of $10,000.00. However, he would not be required to advance any additional funds for taxes since the transfer did not result in any taxable income to him.

Thus in both cases the charity has received $10,000.00 and the taxpayer is entitled to a deduction for that amount. However, the failure to give the securities in kind will have cost the donor the tax on the gain, to the amount of enhancement in value of the property over his basis.

It may appear odd that the law does permit a "tax-free" sale under the circumstances outlined above. As a matter of fact, there have been legislative proposals to limit deduction for contributions in property to the basis of the property transferred, but such proposals have never received much favorable consideration. Legislative action is, however, not the only quarter from which attack may be expected; nor is a limitation on deduction the only form in which such attack may be made. In a recent ruling, the Commissioner took the position that a farmer must include in his income the fair market value of crops donated to charity and for which he claimed a deduction as a contribution under Section 23(o) of the 1939 Code.[57] Undoubtedly, a compelling factor motivating such a ruling was that the farmer had deducted from income his costs of operation in producing the crops donated to charity and a contrary position would have permitted a double deduction.[58]

The ruling was recently tested by the Fifth Circuit.[59] A taxpayer conveyed one hundred calves to the Y.M.C.A. The calves were commingled and raised with the taxpayer's calves, and were subsequently sold to one buyer. The Y.M.C.A. received the portion of the sales proceeds attributable to their 100 calves. The taxpayer deducted the value of the calves as a charitable contribution and deducted all costs incurred in raising the calves. The Commissioner contended that I.T. 3910 and I.T. 3992 applied so that the gift was income to the taxpayer.

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[57] 1954 IRC § 170; I.T. 3910, 1948-1 C.B. 15.

[58] In discussing the gift of income items, in 65 *Harvard Law Review*, Dean Griswold suggests that the inequity created by I.T. 3910, be relieved by legislation which would read as follows: "Where the gift is of property, the deduction shall be in the amount of the fair market value of the property at the time of the gift, except that where the gift is of property which would be included in the taxpayer's inventory, or is otherwise of property which would be fully included in gross income, if the property were sold, then no deduction shall be allowed." This he contends, would prevent the double deduction. Professor Bittker, in his reply in 65 *Harvard Law Review*, states that the distinction drawn by Dean Griswold, between income and capital items as contributions, does not justify this kind of a solution because it would still result in an inequity insofar as the farmer is concerned. Professor Bittker suggests simply that the solution would be to allow the value of the crop as a charitable deduction, without reporting the value as income, but to disallow the expenses of raising the crop. This, he insists, would put the farmer, the investor and the manufacturer on the same basis where the donated items were respectively, the farmer's wheat, the investor's securities and the manufacturer's widgets.

[59] *Campbell* v. *Prothro* (5 Cir. 1954) 209 F. 2d 331. Note that the Circuit Court allowed the farmer to deduct his expenses in full.

The Court held that income may be realized only when the animals are sold. The mere making of a gift is not realization of income. Therefore, since the title to the calves was in the charity at the time of sale, the taxpayer cannot realize income.

The lower court had reduced the taxpayer's deduction of expenses by the amount attributable to that period before the gift document and the sale of the calves. The court further held that the *Horst* case was inapplicable because the gift of the calves was an assignment of income producing property.

In contemplating a gift of property that has enhanced in value, the taxpayer should be careful that the gift is made without an intervening pledge originally made in terms of cash. If a taxpayer satisfied such a pledge to charity by transferring property which has appreciated in value, gain will be recognized in the amount of the excess of the pledge over the basis of the property.[60]

Property that has declined in value. The converse of the proposition discussed immediately above is that property that has declined in value below the taxpayer's cost or tax basis should never be given in kind. Instead, the property should be sold and the donor should then make a gift to the charity of the proceeds of the sale. If the property is given in kind, the donor will be entitled only to a deduction for the contribution in the amount of the fair market value of the property at the time of the gift. But if a sale is made and a transfer of the proceeds then follows, the taxpayer will be entitled to (a) a deduction for the amount of the loss on sale, if it is deductible under the Code, and (b) a deduction for a contribution in the amount of the proceeds turned over to the charity.

Assume that a taxpayer wishes to make a charitable contribution of $4,000.00. He owns marketable securities that have a fair market value of $4,000.00, but for which he has a tax basis of $7,000.00.

a. He transfers the securities in kind to the charity. He is entitled to claim a deduction for contributions for the fair market value of the securities, of $4,000.00.

b. He sells the securities for $4,000.00 and gives the proceeds of the sale to the charity. He is entitled to a deduction for a loss on the sale of the securities under the 1954 IRC Section 211,[61] limited by the capital loss provisions of 1954 IRC Section 1201.[62] In addition, he may deduct $4,000.00 as a contribution.

Thus, in both cases, the charity has received $4,000.00 and the donor is entitled to a deduction in that amount. However, by selling the securities and making a gift of the proceeds, the donor becomes entitled to an additional deduction for the capital loss in the amount of $3,000.00.

Life insurance policies. One form of property that merits separate mention is life insurance policies. They are versatile types of property and lend themselves to an infinite variety of arrangements. For this reason, donors should consider utilization of insurance contracts in their planning for charitable contributions.

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[60] *Estate of John T. Harrington* (1943), par. 43,369 Prentice-Hall Memorandum T.C.

[61] 1939 IRC § 23(a).

[62] 1939 IRC § 117.

If a life insurance policy is irrevocably transferred to a charity, the donor will be entitled to a deduction for its value at the time of the gift. If the policy can be replaced, as single premium or paid-up contracts can, the deduction will be for the amount of the replacement cost.[63] Where the gift consists of a contract that has been in force for some time and on which further premium payments are to be made, or is such that it cannot be replaced, the deduction will be the sum of the interpolated terminal reserve at the date of the gift and the proportionate part of the gross premium last paid before the date of the gift that covers the period extending beyond that date.[64] Generally, the amount of the deduction is slightly in excess of the cash surrender value of the contract.

If the donor, after irrevocably transferring the policy to a charitable organization, continues to pay the annual premiums due on the policy, he will be entitled to a deduction as contribution for the premiums in the period in which he pays for them.[65]

Co-ordination with estate plan. The choice of property to be given to charity is not a decision to be controlled solely by income tax considerations. The determination that certain property should be retained and other property transferred is one that should be made in the light of all circumstances, and should be co-ordinated with the donor's estate plan.

If, other considerations being equal, the donor is in a position to give either of two parcels of property, one difficult to value, and the other whose value is readily determinable, he should transfer the latter to charity. By doing so, he eliminates the valuation problem in so far as his income tax is concerned. If the property that involves a valuation difficulty is transferred to charity in a testamentary disposition, then there is no problem presented, because the value at which such property would be included in the gross estate of the donor is the same for which the estate would be permitted a deduction for charitable bequests under Section 2055 of the Code.

A somewhat similar situation exists where a taxpayer has properties of varying degrees of liquidity. By transferring the less liquid properties to charity, he maintains his own liquidity, eliminates the need to raise cash to meet the payment of a cash legacy, and avoids the sacrifice in values that a forced sale of property might produce. A charity receiving less liquid property is in a better position to dispose of it less hurriedly and to the best advantage. It may even be that the charity can use the property itself.

5. When to Make the Gift

As previously stated in this discussion, contributions by individuals are deductible only if actually paid. A mere pledge, even by an accrual taxpayer, will not support a deduction for income tax.[66] This fact, together with the limitation on the amount of the deduction, makes the timing of gifts to charity an important matter. Since the time of deduction is controllable, this question invites careful consideration of a taxpayer.

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[63] *Guggenheim* v. *Rasquin*, 312 U.S. 254, 25 AFTR 1166 (1941).

[64] Reg. 108, § 86.19(i).

[65] O.D. 299, 1. C.B. 151.

[66] See footnotes 16 and 19.

The problem of a taxpayer who desires to transfer a parcel of property whose value exceeds the maximum contribution to which he is entitled has already been discussed herein.[67] A variation on the transfer of fractional interests in the property becomes worthwhile where the problem is not so much the value of the property, as it is the size of other contributions of the donor.

In such case, he can permit the charity to use the property, but defer making a completed gift until a later period in which the deduction will be more advantageous. If the charity does not wish to embark on use or perhaps improvement of the property in the absence of specific guarantees that it will eventually own it, the donor might consider a conditional or escrow delivery in which title will be conveyed to the charity upon the happening of some future event.

Transfer into charity for notes. Another solution to the difficulty raised by the excess of the value of property over the 30 per cent limitation on deduction is the transfer of property to a charity, in exchange for notes of the charity for the excess of the fair market value over the amount of the initial contribution. In such a case, the donor makes a gift at the time the transaction is completed in the amount of the excess of the value of the property over the amount of the notes.

In subsequent periods, as the notes become due, the donor cancels notes in those amounts that will bring his deduction for contributions up to, but not exceeding the 30 per cent limitation. He will be entitled to a deduction as a contribution for the amount of the note cancelled, in the year of such cancellation.[68]

The particular advantage of this transaction is that it gives immediate use of benefit of the property to the charity, since title passes to it immediately. If the charity wishes, it may sell the property or take other appropriate steps to raise money from it.

A taxpayer contemplating such a transaction must be particularly careful that he does not realize taxable gain on the transfer. If the donor's basis is less than the amount of the notes, he will have a taxable gain.

Gift of notes. If a donor finds that he is not able to make a contribution to a charity because he is not in a sufficiently liquid condition, or because he has exceeded the maximum allowable contribution in that period, he may still give the charitable organization a present benefit. This can be accomplished by the execution of promissory notes in favor of the charity.

Since the notes are not paid in the period of execution, there would be no deduction at that time. However, as the notes are paid, the donor-maker would be entitled to a deduction for contributions in the year of payment.

The charity receives a present benefit, in that it is given something of value, assuming the solvency of the maker of the notes. By negotiating the notes, the charity can realize cash and so enjoys an immediate benefit, even though the donor has not made a present contribution but has committed himself to one payable in the future.

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[67] Discussed under "Multiple Gifts" above.

[68] *Andrus* v. *Burnet* (D.C. Cir. 1931), 50 F. 2d 332, 9 AFTR 1658.

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How to Use Charitable Trusts and Foundations

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The Treasury Department estimates that there are over 30,000 philanthropic institutions in the United States. These institutions have recently leaped into prominence as methods for shielding worldly assets from income and estate taxes. They have been used for this purpose in a wide variety of ways. Most foundations are established to accumulate and use funds for purposes that the founders deem worthy and that the national legislature has deemed sufficiently valuable to the general welfare to merit tax exemption. But altruistic and benevolent motives are often reinforced by personal benefits. The sharp increase in tax rates, the inflation of values and incomes, which throws a given asset or a given level of earning power up into higher rate brackets, the vigorous efforts of the Treasury to prevent individuals from redeeming stock or reorganizing to get liquid assets into their personal hands without a prohibitive tax penalty, have created the most acute personal and business financial problems.

Today's tax structure undermines the value of every closely held company by creating pressure to sell and by siphoning off capacity to buy. Under the tax rates of the last ten years, there has been only one way by which an individual could attain substantial wealth. Only by building up the earning power and asset value of a business has it been possible substantially to improve one's balance sheet. Just as the income tax prevents an individual's building up substantial assets out of ordinary income from such sources as compensation and dividends, it also prevents the owners of businesses from building liquid assets to balance an equity that has appreciated sharply in value. Income tax drains so much from dividends and salary that it is impossible to accumulate enough money to pay the high estate taxes resulting from capitalization of today's high, but largely unreal, level of earnings. Many owners are forced to sell out, rather than run the risk of forced sale to meet estate tax liability. Buyers, at the same time, are losing their power to buy. Just as income taxes drain off the owner's capacity to meet his estate taxes, they also prevent a potential purchaser from accumulating adequate funds. Hence, we had the sudden emergence of tax-exempt universities and foundations as equity buyers because they are in a preferred position to accumulate buying power.

To meet these impending death tax obligations, to provide for their families, to maintain businesses in independent family ownership, individuals have been turning in increasing numbers to the tax protection afforded by institutions with charitable or educational purposes. This trend threatened to assume such proportions that the use of the tax-exempt foundation came under very careful Congressional review, and a new set of legislative principles was spelled out.

1. Points to Consider

Sound planning for the use of foundations requires the consideration of the following points presented in this chapter:

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  Penalties for prohibited transactions .... b
  When loss of exemption takes effect c
  How the tax exemption is recovered .... d
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2. The New Rules on Foundations

Congress has again explicitly recognized the tax-exempt status of philanthropic institutions and laid down important ground rules and limitations on their operation. The much litigated privilege of operating a business free from the burden of income tax has been substantially eliminated. Rents from certain mortgaged property held under lease-back arrangements will also be taxed. All other tax privileges remain intact provided the ground rules are observed.

a. The prohibited transactions. The basic ground rules specifically define prohibited transactions as follows:

1. A loan without adequate security and reasonable interest
2. Payment of excessive compensation
3. Making services available on a preferential basis
4. Purchase of securities or other property for more than adequate consideration
5. Sales of securities or other property for less than adequate consideration
6. Any other transaction which results in a substantial diversion of assets or income

These transactions are forbidden only when the recipient or the party benefited is (1) a creator of a trust seeking exemption, (2) a substantial contributor,

(3) an individual related to such a creator, contributor, or (4) a corporation controlled by him.

b. The penalties. What happens to a foundation that engages in the operations now prohibited? It loses its tax privileges. If the income or corpus of a nonexempt trust that has been "permanently set aside" for philanthropic purposes is used in one of these transactions, the trust loses its unlimited deduction of amounts set aside for such purposes and is limited to the deduction of 20 per cent of its net income. A corporation will also lose its tax exemption under 1954 IRC § 501; 1939 IRC § 101. But the rules do not apply to religious or medical institutions, educational institutions actively operating schools, or associations receiving support from public bodies. Most important of all, engaging in one of these prohibited transactions will result in disallowance of any deductions for gifts, bequests, or contributions made to the institution so engaged.

c. When does loss of exemption take effect? These penalties become effective only for taxable years subsequent to the year in which the foundation is notified by the Treasury that it has participated in a prohibited transaction. Only when the organization acts with the purpose of diverting a substantial part of its income or corpus can the exemption be denied retroactively. A deduction for a gift, bequest, or contribution made to an organization, which improperly diverted corpus, can only be disallowed by a retroactive ruling when the donor or a member of his family was a party to the prohibited transaction. In short, the legislation goes far to insure that once a foundation has been approved as exempt, no innocent giver will lose the tax benefits of his gift merely because the management of the institution, knowingly or unknowingly, became involved in a transaction that falls within the prohibited category.

d. Recovery of tax exemption. When an organization has lost its tax privileges, it will be able to recover them if it can satisfy the Treasury that it "will not knowingly again engage in a prohibited transaction."

The probable requirement of reinstatement will be a specific prohibition of transactions that may fall into the prohibited category, written into the charter or indenture creating the institution seeking tax-exempt privilege. Indeed, it would seem to be a good policy to write such restrictions into charters and indentures creating tax-exempt foundations from the beginning.

e. Protection against loss of exemption. How can the management of a foundation protect itself against unwittingly engaging in one of the prohibited transactions? What are the standards? It does not seem to the writer that the standards are substantially different from those that govern in the operations of a private corporation, particularly when the stock is publicly held. A test of reasonable allowance for salaries or other compensation would seem to be met if salaries are in line with those paid for similar work, so as to qualify for tax deduction under 1954 IRC § 162; 1939 IRC § 23(a), if the foundation were a taxable institution. Adequate security and a reasonable rate of interest merely require that any loan between a foundation and a creator, or substantial contributor, if desirable at all, be on terms that a banking institution might be expected to make. Comparability of services can be tested by the price or prevailing charges for comparable services. The acquisition of property from, or the sale of property to, a related party can be satisfactorily tested by other bids and offers and by competent appraisals.

f. Unreasonable accumulation or use. Tax-exempt institutions, except a religious, medical, public body, or an educational group actively running a school, lose the tax exemptions on their incomes, *not* gifts and bequests to it, if funds accumulated during the current year or any prior year for allegedly philanthropic purposes are:

1. unreasonable in the amount or the duration necessary to accomplish the purposes of the institution,
2. invested in such a manner as to jeopardize the carrying out of such purposes, or
3. used to a substantial degree for ulterior purposes.

The exemption is lost only for the one year involved. If accumulations for the current and prior years are disbursed or properly invested, the organization becomes exempt again automatically. It is clear from the legislative history and from the practice of the most firmly established foundations that it is not essential to use all the income every year. It is not so much the amount of income paid out, but the amount accumulated and its relationship to the purposes of the institution. It would seem that, if the purposes of a foundation are to provide the income to support a significant work of some sort, the income can be accumulated, together with subsequent gifts, until the capital has become sufficient to yield an income adequate to carrying on the specified work on a definitely established basis. Thus, the requirement, with respect to the accumulation of income, will vary in its application within reasonable limits, depending on the purposes of the foundation.

g. Publicity. To operate as a further curb on the accumulation of income by tax-exempt bodies, with the exception of religious, medical, and actively educational groups, there must be additional financial information beyond that required on the present information returns called for on Form 990. A balance sheet showing financial position as of the beginning of each year must now be filed, and this information must now be made public.

h. Business income. Business income in excess of $1,000 will be taxed to an otherwise exempt institution. This applies to trade or business "regularly carried on and not substantially related to the purposes of the organization." A nonexempt trust cannot deduct income from a trade or business regularly carried on, even though it is set aside for charitable purposes. Business income is not taxed if substantially all the work is performed without compensation, if it comes from selling merchandise, most of which was acquired by gift, or if the business is conducted primarily for the convenience of members, students, patients, officers, or employees. These exemptions are designed to exclude such things as a thrift shop, a college laundry for students, rummage sales on behalf of a children's home, and similar activities.

i. Exempt income. Of greatest importance is the fact that certain categories of income are expressly declared to retain their tax exemption when received by an exempt institution:

1. Dividends.
2. Interest.
3. Annuities.
4. Royalties, including overriding royalties, whether measured by production or by gross or net income from the property.
5. Rents from real property, except when the rents are made taxable by the existence of debt in connection with the acquisition or improvement of the property.
6. Gains from the sale or exchange of property other than stock in trade.
7. Income from research for the government, whether on Federal, state or local level.
8. Payments for research work received by colleges, universities, hospitals, and organizations primarily dedicated to fundamental research for the public benefit.

j. Rentals arising from lease-back. Net rents from a long-term lease of real estate will be taxable in the proportion that unpaid indebtedness, incurred in connection with the property, bears to its adjusted basis. To render such income taxable, these facts must exist:

1. Certain rents received by tax-exempt corporations, arising under a business lease of real property for a term of more than five years, are still regarded as unrelated business income. Now, such rents are treated as from business leases, even though the lease is for less than five years, where the same business tenant occupies the property for more than five years, but tax applies only in the tenant's sixth year of occupancy.
2. The owning institution must, at the close of a tax year, have outstanding an indebtedness incurred for the purpose of purchasing or improving the property. This indebtedness need not be a mortgage on the property. It may have been incurred before or after the property was acquired. The test is whether it would exist if the property had not been acquired.
3. Indebtedness incurred before July 1, 1950, or subsequently incurred in making improvements pursuant to a pre-existing lease, are not counted, if the property was held by an exempt investment subsidiary, one-third of the stock in the subsidiary having been acquired by gift and all of the stock having been acquired prior to July 1, 1950, or if the property itself was acquired by gift or bequest prior to that date and was subject, at the time, to a mortgage or similar lien for the indebtedness.

There are many intricate problems with respect to the taxability of rental income when the foundation has incurred an indebtedness than can be traced to the ownership of the property. How much of the property is under lease for five years; whether the debt was actually incurred in connection with ownership of the property; the allocation of income and expense, in accordance with the degree to which the property is covered by related indebtedness, when only part of the property is under long-term lease and the balance under short term: all of these are problems of great detail and intricacy that must be carefully studied by any foundation owning real estate and having an outstanding debt.

3. How Foundations Can Now Be Used

The result is that Congress has fully approved the decent family foundation, despite many pleas to outlaw it. It has merely set up some new rules, *reasonable rules, easy rules to follow.*

Anyone can establish a family foundation. Anyone with much income or capital will be able to accumulate significantly more dollars in a foundation than in a corporation, trust, or personal portfolio.

But whether you should create a family foundation depends fundamentally on your answer to another question. Is there some activity (religious, educational, research, charitable, social) that interests you, to which you might want to devote yourself later on, in which your children might want to engage? If your answer is "Yes," you want to read further.

Is your interest in this work strong enough to move you to create a foundation and put money into it? That will depend, in part, on a comparison of how dollars are preserved in your personal pocketbook, the corporate pocketbook of your business, or the tax-exempt pocketbook of a foundation.

Think of it this way. A profit-making corporation is an institution through which you engage in economic work. A foundation is an institution through which you can do religious, educational, or charitable work. What you can do with a corporation or with a foundation depends, to a large degree, on how much you can invest and accumulate in it. Because foundation work is deemed socially desirable, a foundation gets enormous tax privileges. These make it possible to conserve assets and to build up funds more easily than in a profit-making corporation.

a. What you can't do. Congress has established ground rules against diversion of funds. If they are violated, the foundation loses its tax privileges. These rules allow you to borrow, if the terms are in line with banking practice, and to buy or sell assets, if the terms are kept strictly in line with real value. You must see that any transaction is backed up by qualified appraisals, or other bids or offers.

Business income is now taxed to the foundation. So are rents from leases over five years, to the extent that the foundation incurred debt to acquire rental property. But other rents, dividends, interest, royalties, and capital gains are received tax-free.

The new law says that, if a foundation owns or operates a business, it must pay a tax on its business income. Its tax-exempt income consists only of investment revenue: interest, dividends, royalties, rents (except long-term, lease-back rent, acquired or improved with borrowed funds). If it has income from a business or from the prohibited long-term, lease-back operations, that is taxed. So we may lose the advantage of the tax-exempt income on these items to the foundation. If the foundation owns a subsidiary business company, it is taxed as a regular business operation. But we get full tax exemption for the foundation —*get a full tax credit for gifts to it*—if its income is of the investment type and if its disbursements are reasonably close to its receipts. (It does not have to disburse all it received.)

You or your family are not prohibited from dealing with a foundation. But remember, first, that the foundation carries with it a fiduciary responsibility. You cannot engage in transactions with your foundation unless they will improve its income or asset position. If you meet this test, you can benefit, too, by improving liquidity, getting financed, realizing capital gains.

The prohibitions are simple. All you must do is *not* to give the family (out of any income or principal) any of these advantages:

1. Lending to them, without adequate security, or at an unreasonable rate of interest;
2. Paying them compensation over a reasonable allowance for personal services actually rendered;
3. Making any services available to them on a preferential basis;
4. Buying from them or selling to them substantial securities, or property, for less than an adequate consideration;
5. Engaging in any other transaction with them resulting in a substantial diversion of income or principal.

b. What you can do. If it follows these simple rules, as we shall presently illustrate, the tax-exempt foundation can:

1. Retain much of the benefits of wealth, even though the wealth has been given away.
2. Be used to protect capital from tax erosion (money lost by persons with high incomes).
3. Have the donor or his family administer the foundation. You don't have to bring in strangers who have no personal stake in the family business. A family can vote the stock held by the foundation, setting all its business policies on compensation, dividends, reorganizations.
4. Retain funds in the foundation. All the law requires is that the foundation pay out what is reasonable in order to carry out its purposes. It can invest its money, if that does not jeopardize the interests of the religious, charitable, scientific, etc., beneficiaries.

All that the new law requires is honest dealing between the foundation and the donor, both recognizing the purpose for which it was created. The government will check that annually in a new way, securing from all foundations reports of their income, expenses, accumulations, balance sheets.

4. What Is a Foundation?

A foundation is a non-profit organization, not a governmental body. It has its own fund; its income and principal are used for public welfare. It may be a corporation, a trust, or an unincorporated association. Where permanence is wanted, the corporate form is generally more desirable; it is more generally used.

It must provide that no part of its funds are to benefit anyone except religious, scientific, educational, or charitable groups. It should also bar propaganda activities or those designed to influence legislation.

The properly organized foundation pays no taxes to the Federal government; yet we may organize it so that we fully control its activities.

5. Why the Foundation for Businessmen?

Many reasons urge use of the tax-exempt foundation. With present-day income and estate tax rates, the foundation seems to be the last method available to permit diversion of capital to sources of one's own choosing. Perhaps it is one of the few processes left by which we can now begin to accomplish the job previously completed by capital built up by income or property appreciation. Here are seven very important reasons:

1. We can keep control of wealth. Our tax structure, through heavy estate and gift taxation, makes it impossible for wealthy men to give large gobs of their capital to their families, unless we fit them into these organizations especially favored by the tax law. And yet in doing that, family control of a business can be maintained by preventing the sacrifices needed to pay the heavy estate taxes. Even if voting stock is given to a foundation, control is retained this way: members of the family can dominate the foundation as directors, trustees, or as administrative officers—so that they manage almost everything, including the dividends from the contributed stock.

If we give stock to a family foundation, we get a *triple* break: (1) we save the tax on the appreciation of the stock values, (2) we get a large income tax deduction for the contribution at the increased value, (3) we avoid the substantial estate taxes paid upon death. Moreover, if gifts are made to the foundation over a period of years, we multiply the benefits obtained.

2. The foundation can keep for the donor many attributes of wealth by many means. A few of these are:

Designating the administrative management of the foundation or control over the investments comes by using the power of his influence, especially by his promise of future contributions. He controls in almost every respect, as though he still owns the stock, except that he does not receive the dividends.

By appointing relatives as directors of the foundation, he insures control by persons closely tied to the desires of the donor.

A foundation's assets can be used to borrow money to buy other property that does not jeopardize its purpose. Thus, foundation funds can be enhanced from the capitalization of its tax exemption.

3. The foundation can keep income in the family. It may secure all sorts of direct or indirect payments or savings to members of a family. For example:

Sometimes it can get funds subject to payment to the family. All the interests in property need not be given away. Life interests, or life estates, can be retained by a donor or his dependents; a remainder interest can be given to the foundation. An annuity can be given to the foundation, or property, subject to an annuity for one or more lives, can be donated.

It can buy property for a fair price, so it can give a capital gain. Great aid can come in securing capital gains (instead of dividends) in this closely held company. Assume that Smith owns the Smith Corporation. Smith wants to organize the Smith Foundation to conduct cancer research. He organizes the foundation so that it enjoys exempt status. He gives it money, for which he gets a charitable deduction. The foundation will pay no taxes to the Federal government. Smith might also personally sell to the foundation all of his Smith Corporation stock for a fair consideration. Its earnings can be transferred as a dividend without tax to the foundation. It can pay Smith for the property as he is then subject only to a 25 per cent tax, since the transaction would be called a capital gain.

It can save personal income taxes, via the contribution deduction.

It can distribute the charity *when* it seems most desirable to do so. That may be at any time, even in the distant future; still the donor gets a contribution deduction in the year of his gift. We avoid hurried decisions as to when and how much to give away.

4. Family foundations can aid employees of the donor's business and therefore contribute to its productivity and good-will. Court decisions permit us to set up charitable foundations for the benefit of the employees of a *single* corporation. When the objectives of an organization are to extend aid to employees in cases of death or sickness or distress, it seems clear that the motive is charitable. One of the commonest forms of charity is aiding the sick, the afflicted, and those in distress.

Assume we want to help employees of a particular company. We can arrange to set up a trust to carry out the purpose approved by the courts. It can be agreed to give the trust annual gifts of property and get a deduction up to 20 per cent of our annual adjusted gross income (or 5 per cent of a corporation's net income).

5. Foundations may well be the method of insuring that funds will be available for use in new ventures in business. The foundation protects this money; it can be used for industrial expansion. The foundation can preserve capital appreciation. It can protect funds from the erosion of the tax system. By it, funds may be retained for the competitive effort of enterprises in which individuals are interested. Ordinarily that cannot be accomplished out of liquid funds available from ordinary dividend or salary income.

6. We can avoid income from property while it is slowly being given to a foundation. If individuals give to a foundation, tax economy suggests this: they exclude immediately (from their own income) all of the earnings of the property put into the trust. At the same time, they want their full 20 per cent charitable deduction over as long a period of years as possible.

7. We can get the 20 per cent charity deduction in other ways. For example, by giving away appreciated property, we escape a tax on the realization of a gain.

We can give funds to a foundation to get the charitable deduction currently in our most advantageous tax year. The foundation can hold on to a *reasonable* amount of funds, to accumulate the income; then it can use the money in the years when it can do the most good for the beneficiaries. Add, too: the foundation protects the businessman from the avalanche of charity requests from employees and others that regularly come to him. These requests can be passed on to the foundation created for that purpose. Many charitable needs and demands upon potential donors are greatest when economic conditions are depressed and employment low. Yet the ability to give and the tax benefits from charitable deductions are generally highest during prosperous years. Then incomes are high and tax rates up. By giving the funds to the foundation, the donor gets the deduction currently. He can give in his most advantageous year. The foundation, however, can hold on to the funds, even accumulate the income, and then use them in the years when they can do the most good to the beneficiaries.

Often local personal and real property taxes can be avoided; we can give taxed property to a philanthropic foundation.

We can avoid speculative profits. Say we are engaged in stock, realty, oil, and other speculations: We may not wish to stay "long" on speculative holdings. Yet we may anticipate a sharp decline in values. The tax laws prevent a sale without incurring substantial taxes for the appreciation. By giving the property to a foundation, we can avoid the risk of a drop in values of speculative holdings. The foundation can sell immediately on receipt of the gift without incurring a tax; even sell precisely at the time the donor takes a substantial contribution deduction.

He can give away valuable "frozen assets"; white elephant estates, residences, valuable works of art, and collections of all sorts. Their enormous values may swell the size of the estate taxes to the extent that they would have to be auctioned off to raise cash to pay taxes. By giving them to a foundation, not only are estate taxes saved, but the valuable contribution deduction can be taken.

6. How a Foundation Works Financially

Let's take a case and see how much more money will be available for use in a foundation than in the family's private treasury—ten years from now; after death.

Assume salary, dividend, and investment income can be figured at $80,000 a year.

Net worth is $400,000, plus 72 per cent of a business appraised at $620,000.

The stock cost $50 a share. Today it's worth $667 and pays dividends of $50 a share.

Suppose you create a foundation and give it $12,000 a year. The annual income tax bill is cut from $39,480 to $31,520. Of the $12,000 gift, $7,800 is tax money, $4,200 comes out of your personal pocketbook.

This $4,200, kept in your personal portfolio, earning 4 per cent compounded, but taxed in the 66 per cent bracket, would accumulate to $47,400 in ten years. The $12,000 in the foundation, earning 4 per cent compounded tax-free, would accumulate to $148,830. So, your first comparison is whether you'd be prepared to exchange $47,400 free for personal use for $148,830, which you and your family can have ten years from now to do the work that interests you.

You can actually improve your family's current cash position, while building up the foundation. Instead of cash, you give $12,000 worth of stock each year. This cuts your income tax and increases your family's after-tax cash income by $7,960 each year. Compare this with a sale of $12,000 worth of stock to an outsider. You'd lose the stock entirely and improve the family cash position by $9,225 a year. With the foundation, it costs you $1,625 out of pocket to keep the stock, and its income, for future use in your foundation. That's not the whole story either. The gift to the foundation lifts a future estate tax lien. At a 32 per cent estate tax rate, this charge will be some $2,900. So, the foundation not only gives you liquidity, retains control over the stock, preserves assets and income for future use, but it actually does more for your family's ultimate asset position, by $2,275, than any other disposition of the stock.

Here's the comparison:

Disposition of Stock		*Your Family Nets*
Sale	$ 6,325 —	$9,225 cash, less $2,900 estate tax
Keep stock and pay estate tax	$ 8,160 —	$12,000 stock, less $3,840 estate tax
Will to foundation	$ 3,840 —	$3,840 estate tax saving
Lifetime gift to foundation	$10,860 —	$7,960 income tax saving plus $2,900 estate tax saving

What about your family after your death? Estimate Federal estate taxes at $100,000 with the full marital deduction, $245,000 without it. With the marital deduction, we must count on a $200,000 estate tax bill over the life of husband and wife. This presents the prospect that your executor would have to sell the stock interest in your business or use a large slice of liquid assets to meet death liabilities.

What other alternatives would a foundation afford? Here are the important financial comparisons:

Roughly, for every $2 net you can leave your family for private use, you can leave $3 for them to carry on the work of the foundation.

In its first ten years, the foundation, in addition to cutting your income tax bill by $79,600, has reduced the estate tax bill by 32 to 37 per cent of $47,400.

If your will leaves all the company stock to the foundation, the maximum estate tax exposure is cut by $153,000. If your family retains 51 per cent of the stock and the foundation gets your remaining 21 per cent, the potential cash drain is cut by $70,000.

By leaving your wife, age 60, the life income from $400,000 of company stock and the remainder to the foundation, you eliminate about $240,000 from your estate. This cuts the estate tax bill almost $80,000.

Assume you've put $12,000 a year into a foundation for ten years and then give it $300,000 by will. At a 4 per cent yield, the foundation would have about $26,000 of annual income. The same money willed to children in a 50 per cent income tax bracket would give them about $8,000 a year for personal use.

Collateral advantages may be important. Control and management of the family business can be retained though the stock goes to the foundation. A pool of capital is built up. Your family is not prohibited from dealing with this fund, provided their fiduciary responsibility is respected, the assets and income position of the foundation are scrupulously protected, and dealing is on an arm's length basis at market terms.

7. Foundations in Estate Planning

Inflation has pyramided the taxable value of business interests and other income-producing assets; on the other hand, high taxes have made it substantially impossible to accumulate sufficient liquid assets out of dividends and salary to pay the resulting death tax liability.

The death of the owner of a business creates a liability which, more and more frequently, exceeds the liquid resources available to meet it. Even though the owner provides against this contingency with as much life insurance as can be prudently purchased out of income after taxes, there is likely to be a considerable gap. In the absence of other precautionary steps, this gap will bring about a forced sale of all or part of the business interest.

Or, frequently, sound planning for the security of a widow and children will not allow the consumption of all liquid assets to pay estate tax. The effect might leave family security dependent on a business which has lost its driving force.

In these situations, control of the business plus a cushion of liquid assets may be preserved *by making a tax-exempt gift or bequest to a charity or a family foundation.* Enough value may thereby be taken out of the taxable estate to bring the tax liability down within the reach of the available liquid resources.

Ford Foundation illustrates modern estate planning. The case of the Ford Motor Company shows how giving can be effectively tied into estate planning. The taxable value of the company was so great when first Henry Ford and then his only son died, that there were only two available methods of dealing with the resulting tax liability:

1. Sell most of the stock to the public and raise enough cash to pay estate tax liability on all the stock owned by Henry Ford and Edsel Ford when they died.
2. Give enough of the stock to charity to bring the estate tax liability down to a level which could be met out of family resources.

The latter method was chosen. The stock of the motor company was reclassified into a voting common and a non-voting common. Ninety per cent of the equity, in the form of non-voting common, found its way, free of transfer tax, into the Ford Foundation established by Henry Ford for charitable purposes prior to his death. The executors of Henry and Edsel Ford were able to pay estate tax on the 10 per cent of the equity which remained in family hands. The family still has 100 per cent of the voting power. Ninety per cent of the asset value and dividend income is in the hands of a foundation, at first under firm family control but now substantially converted to a public trust in which the voice of the Ford family is quite strong if not dominant.

Ford's solution can't yet be fully appraised. It depends on the ultimate disposition of the Ford Motor Company stock now held by the foundation . . . the relative value of (a) the working control which the Ford family would have retained even if they had sold enough stock to the public to pay the full estate tax bill *as against* (b) that of the full voting control now enjoyed subject to the fiduciary responsibility to the foundation . . . the way the present generation of Fords will move to preserve their position for their children. But the family has at least solved the gigantic hurdle of keeping business control while going through the estate tax mill.

Small businesses face the same problem as the Fords. Today, even the small businessman can have Henry Ford's headache. The inflation in dollar values has accomplished an unlegislated increase in the real burden of the estate tax rates as well as the capital gains tax. At the same time, increased income tax rates have cut heavily into the ability to save. The effect confronts the owners of many medium-sized and even small businesses with the problem of the frozen estate, in an earlier day confined to the Fords, the Mellons and the Rockefellers.

It can be an even stickier problem for the smaller business. If liquidity can't be developed by use of the marital deductions and other methods of reducing or spreading out the death tax bill—plus the use of life insurance and other methods of raising the necessary cash—the executor of the small business owner does not usually have one of the alternatives available to the Fords: that of selling off part of the business to the public while retaining working control for the family. When the small owner sells out, control is far more likely to go along with the business.

In December 1949, W. T. Hackett, trust officer of the Huntington National Bank of Columbus, Ohio appeared before the Joint Congressional Committee on the Economic Report. He presented an analysis of the last twenty estate planning jobs he had completed. These represented owners of small businesses who had come to his bank to discuss their estate plans during the years 1948 and 1949.

Mr. Hackett presented the liquid assets of each man; the semi-liquid assets, such as a home; the book value of the business; the business value if earnings were capitalized, to arrive at a figure for estate tax purposes and the resulting estate tax liability. Of the twenty cases, fourteen faced a probable death tax liability which exceeded the liquid assets available to meet it. Four men had already anticipated this problem and sold their business interest to put themselves in liquid condition; the two others were a salaried man and a man whose business was quite small who had saved enough in liquid assets to meet the tax bill.

The chart showing *Composition of Nine Estates,* taken from Mr. Hackett's testimony, will indicate how this problem arises.

Use of the foundation to provide liquidity. How can we close the gap between liquid assets and potential estate tax liability? All practitioners of the estate planning art know that the snowballing of the number of foundations listed as tax-exempt by the Treasury is in fairly direct proportion with the number of smaller businesses brought into the estate tax-liquidity squeeze by the crushing process of inflation and high taxes and the number of owners who are alerted to the impending danger before death.

All in all, it is now clear that *even the small business owner has come to consider a bequest of some of his business to a family foundation or to an established charity* as a method of preventing forced sale of all of the business to pay taxes.

Here are three broad methods of easing the estate liquidity problem by planning with a family foundation or a charity:

1. Bequest of enough of the value of the business to reduce the estate tax bill to a level which can be met.
2. Annual lifetime gifts of parcel of stock to a charity and use of resulting income tax savings to carry insurance or otherwise build up additional liquidity.
3. Bequest of a remainder interest to charity, thus giving the full income value to heirs for their life, yet reducing taxable value by the value of the remainder interest.

How much of a business goes to a foundation or a charity will usually be a matter of arithmetic. All depends on how much of the equity must be protected from the estate tax in order to reduce the tax liability to a figure which can be managed. We have seen that, in the case of the Ford Motor Company, 90 per cent of the equity went to the Ford Foundation; the family had to be content with 10 per cent.

COMPOSITION OF NINE ESTATES

Type of Business	(1) Liquid-Marketable Assets	(2) Semi-Liquid Assets	(3) Close Corporation, Partnership and Proprietorship Investments (Book Value)	(Est. Tax Value)	(4) Total Estate	(5) Estimated Succession Taxes
Manufacturer	$236,150	$352,000	$859,900	$960,030	(a) $1,548,180 (b) 1,448,050	$617,624
Auto Dealer	129,400	120,000	138,116	470,116	(a) 719,516 (b) 387,516	162,992
Income-Producing Real Estate	59,811	141,817	381,117	440,166	(a) 641,794 (b) 582,745	296,904
Auto Dealer	77,457	95,600	91,760	189,131	(a) 362,088 (b) 264,717	138,227
Glove Manufacturer	45,692	146,332	330,950	587,224	(a) 779,248 (b) 522,974	236,829
Cannery, Wholesale Grocery	108,679	15,000	452,938	867,158	(a) 990,837 (b) 576,617	320,763
Vending Machines	18,625	53,190	45,510	138,987	(a) 210,802 (b) 117,325	50,109
Chain of Dry Goods Stores	29,150	157,695	158,755	363,710	(a) 550,215 (b) 345,600	107,019
Auto Dealer	14,180	98,640	68,736	268,736	(a) 381,556 (b) 181,556	95,792

(1) Cash, listed securities, Government bonds.
(2) Real estate, life insurance and death benefits of annuities payable under settlement options, notes receivable, tangible personalty.
(3) Closely held business interests valued at book value and on a capitalized earnings basis.
(4) Total value of estate if closely held business interest is valued (a) at the *higher* of book or capitalized earnings value; or (b) at the *lower* of the two values.
(5) Total of statutory administration expenses (attorney's and executor's fees), Federal estate taxes, and State inheritance taxes that will be imposed in each case, if the higher tax value is established for business interest, by the time the estate reaches present owner's heirs.

Foundation's role where estate is liquid. Frequently, the estate plan will call for a bequest to a foundation even though there is enough cash in the picture to meet estate tax liabilities. Rather than consume all liquid resources to meet the estate tax bill, it may seem more prudent to conserve a large slice of the liquid assets and give a large slice of the business to a foundation. In this way the family is left with a cushion of liquid assets—is not entirely dependent on a business bereft of its guiding hand—while still retaining control of the business.

Take a business worth $1,000,000. The owner also has $560,000 in cash and marketable securities. Federal and state death taxes would consume $528,200 of the liquid resources if the owner died with all his holdings taxable without benefit of the marital deduction.

He can give his family control of his business plus $325,000 of his liquid resources if he puts 80 per cent of the business value into a preferred stock or debenture and gives it to a foundation. It may be sounder security planning for his family to have a liquid cushion of $325,000 and control of a million dollar business subject to an $800,000 claim held by a foundation than to have the business free and clear and nothing else.

Trend to bigger charitable bequests. As the pressure to create foundations to escape the estate tax hammer moves down the size scale from the Ford level, the saving from charitable bequests becomes proportionally less as estate tax rates become smaller. We must part with a bigger percentage of the business to achieve significant savings as we move down the scale in business size.

Also, since the heyday of Henry Ford, the income tax has made deeper inroads into capacity to save. The effect again is to stimulate bigger bequests—as the gap between liquid funds and estate tax liability increases, it becomes necessary to part with more of the business to close the gap.

The availability of the marital deduction—exemption one-half of the adjusted gross estate if it goes to a spouse—has eased the pressure, but not enough. The full estate is still taxed over the life of husband and wife, and inflation and higher income tax rates are not nearly made up for by the saving in the division of property to bring lower rates into play.

How to set up the bequest. There are various methods of splitting the equity value of a business to give value to a foundation and retain control in family heirs. Indeed, there are circumstances in which the estate plan may call for giving family heirs the security of a preferred position while giving the more volatile common stock to a foundation under the control of trustees named by the owner in his will.

The Fords achieved their plan by creating a non-voting common. The creation of a non-voting common stock can usually be accomplished in a tax-free recapitalization.

Where we can get the common out of the estate by life-time gifts or bequests to a foundation, we reduce the problem of valuation of the volatile going-concern element. Preferred stock will usually get a value within fairly predictable margins of its face or call value.

There are distinct advantages in giving interest-bearing debentures to a foundation. Interest payments to the foundation are deductible to the business, whereas dividends on stock are not. We may encounter substantial income tax hazards in seeking to recapitalize in order to create a debenture to give to a foundation.

But the advantages of giving a debenture to a foundation rather than a preferred stock are so considerable that various methods of arranging it are currently being used. For example, the business may be sold to a new company with a stock and debenture capital structure, even though a holding company results from the process.

Lifetime gifts to build liquidity. If liquidity considerations are to force a segment of a business into foundation ownership, it is in a way wasteful to have it all occur by bequest at death. A double tax saving is available from a systematic plan of giving a portion of the business to the foundation during each year of life. The subject of the lifetime gifts is effectively removed from the taxable estate. It is also deductible, to the extent of 20 per cent of the giver's income, on the annual income tax return, and the new law permits an extra 10 per cent under certain conditions. Thus, lifetime gifts, while achieving the same reduction in liability as bequests, also generate additional liquidity as they produce annual savings of cash which would otherwise be payable as income taxes.

Thus, a 50-year-old man owns a business worth $1,000,000. His income is $100,000 a year. If he gives $20,000 worth of stock in his company to a foundation, he reduces his annual tax bill from about $57,000 to about $43,000. Thus, he increases the cash available to him every year by some $14,000. If he does this for twenty years, he will have built up some $300,000 of liquid assets and will have given 40 per cent of his business to a foundation. He has lost dividends on the stock given to the foundation, but the cash tax savings realized each year are more important than the after-tax value of dividends diverted to the foundation.

If he had waited until death to direct 40 per cent of his stock to a foundation, his estate would still have only 60 per cent of the business but would be without the $300,000 of liquid capital accumulated from annual income tax savings realized by anticipating his testamentary bequest by making regular lifetime gifts.

The amount of liquid capital which can be accumulated for death tax purposes out of such annual income tax savings will depend on the number of years of life and the income left to the owner of a business. A fixed amount of liquid capital at the time needed can be guaranteed by buying life insurance with the income tax cash saved by annual gifts of stock to the foundation.

Bequest of remainder interests to charity. The impact of death taxes can be reduced while giving all available income value to one's heirs by providing in a will that named heirs get full income from the property for life, but *that it goes to a charity upon the death of the income beneficiaries.*

The bequest of a remainder interest to charity will reduce the estate tax drain on the capital value of one's property and maximize the income-producing power of one's estate. This approach is of particular value when there appears to be no further generation of heirs to enjoy the use of one's property, as, for example, when one's only family obligation is to provide income for a childless wife or a spinster sister or daughter. The heir is given the life income earned by one's property, with the corpus going to a charity on the heir's death. The estate tax, then, falls only on the value of the life interest.

The value of the remainder interest, which enjoys exemption, is determined by multiplying the value of the property by a fraction opposite the age of the life beneficiary. This can be determined from tables contained in a pamphlet entitled

"Actuarial Values for Estate and Gift Tax," which may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington 25, D.C.

Take a $500,000 estate to be left to a 60-year-old sister. It consists of securities yielding 5 per cent. If it were left outright, she would have $370,000 earning 5 per cent after payment of $130,000 in New York State and Federal death taxes. That would give her an annual income of $18,500. If she took the $370,000 and purchased an annuity, she would get $21,700 a year, of which $20,181 would be returned to her tax-free. The purchase of an annuity would, of course, consume the entire estate.

If, on the other hand, the $500,000 were bequeathed to her for life and then to a charity, the estate tax would apply to only about $200,000. The estate tax bill would recede to $34,000. She would enjoy annual income of $23,300 and the $500,000 would be preserved for use by a foundation or charity.

Power to invade the charitable remainder. The testator may wish to reserve his capital for charity, yet he may hesitate to expose his life beneficiary to the risk that income may be inadequate to meet needs while the capital is beyond reach. He will undertake to resolve this conflict by providing that the corpus reserved for charity may be invaded to meet the needs of the life beneficiary. But this is a very delicate operation. If the extent to which the power of invasion can be exercised cannot be fixed as of the date of death, the charitable deduction will be lost.

A power to take from principal the sums "necessary to suitably maintain her in as much comfort as she now enjoys" sustained a deduction of a charitable remainder.[1] Recently, a power of invasion for the beneficiary's "comfort and welfare" was held to permit an adequately definite measurement of the charitable remainder.[2] However, mandates to invade corpus for the beneficiary's "happiness" or "pleasure" or "as my wife may desire" were deemed to be so broad that the value of the charitable remainder could not be ascertained and, accordingly, the full corpus was taxed.[3]

Some mechanics of planning with foundations. One of the most striking advantages to be derived from donations or bequests to a foundation is the flexibility available in arrangements designed to meet the need for personal and family security. The founder may wish to have income from the property paid to himself as a named beneficiary for life. In this situation, the gift or estate tax is imposed on the value of the life income, computed actuarially, and the taxable estate is reduced by the value of the remainder interest.[4] For older life beneficiaries such an arrangement provides a sufficient degree of security and excludes a substantial part of the value of the property from the donor's taxable estate. In other situations, a reverse arrangement may be desirable. For example, the donor may provide that both the property and income be made available to a minor beneficiary at majority or some other age, because the use of the income will not be required until that time. No death tax will be payable on the present value of the income for the period between the donor's death and the date on which the beneficiary reaches the designated age.[5]

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[1] *Ithaca Trust Co.* v. *United States,* 279 U.S. 151.

[2] *Blodget* v. *Delaney* (1 Cir. 1953), 201 F. 2d 589.

[3] *Merchants National Bank of Boston* v. *Commissioner,* 320 U.S. 256; *Union Planters National Bank & Trust Co.* v. *Henslee,* 335 U.S. 595.

[4] *Henry L. Ickleheimer, et al., Executor,* 14 B.T.A. 1317 (1929); *Estate of Nellie H. Jennings,* 10 T.C. 323 (1948).

Where liquidity and control constitute the paramount planning problem, assets transferred to the foundation should be sufficient to reduce the estate tax to a point where payment can be made out of liquid funds remaining available for that purpose. Therefore, it is generally desirable that the more liquid assets be retained and that property less easily convertible to cash be given to the foundation.

On the other hand, the primary problem may be the danger of a serious dispute over valuation of assets included in the founder's taxable estate, a danger which crops up frequently under the current conditions of inflated and overstated earnings To meet this difficulty, it may be advisable to transfer assets of uncertain value to the foundation, giving special consideration to equity securities for which there is no active market and to assets that have undergone a substantial increase in value since they were acquired.

Although there is a substantial area of flexibility in the use of a foundation to provide life income, there are definite danger zones. The exemption for a gift or bequest to a foundation may be defeated if there are contingencies that make it uncertain whether the foundation will ever enjoy the benefit of the property.[6] Such contingencies will arise if annuities to primary beneficiaries are subject to an indefinite increase and payable also out of corpus;[7] a power of appointment may be used to defeat the charitable gift;[8] a primary beneficiary dies without wife or issue, even though by the time the tax is finally determined the primary life beneficiary has actually died without wife or issue and the charitable organization has received the corpus;[9] a named female should die without issue unless the possibility of issue is so remote that it can be ignored.[10]

Finally, the amount of the gift or bequest must be ascertainable. Thus, a remainder to charity, after the payment of annuities to a number of persons, and numerous other provisions, was held not to be presently ascertainable. However, where a bequest is subject merely to an intervening life estate, its value is definitely ascertainable from mortality tables and that value may be taken as a deduction.

Faulty wording in making a bequest is often responsible for disallowance of charitable bequests in estate tax returns. If the amount of a large charitable bequest seems to be unascertainable because of the provisions to which it is subject, it should be divided into two or more bequests to meet any contingency or uncertainty. The result may prove to be a partial deduction instead of none whatsoever. Likewise, if a power of invasion is desirable, it should be limited as to the amount.

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[5] *United States* v. *Pierce* (8 Cir. 1943), 137 F. 2d 428.

[6] Reg. 105, Sec. 81.46; *Newton Trust Co.* v. *Commissioner* (1 Cir. 1947), 160 F. 2d 175.

[7] *Boston Safe Deposit & Trust Co., et al., Executors*, 30 B.T.A. 679 (1934), dismissed (1 Cir. 12-10-34).

[8] *George W. Davison* v. *Commissioner* (2 Cir. 1936), 81 F. 2d 16; *Charles L. Burdick, et al.* v. *Commissioner* (2 Cir. 1941), 117 F. 2d 972, cert. den. 314 U.S. 631.

[9] *City Bank Farmers Trust Company* v. *United States*, 5 F. Supp. 871, affirmed (2 Cir. 1935) 74 F. 2d 692.

[10] See note 7, above.

8. Trust or Corporation?

Under the Federal revenue statutes, the test of exemption status is the purpose for which an institution exists. In form, it may be exempt under 1954 IRC Section 501 (1939 IRC Section 101), which specifies the qualifications that must be met by a legal entity in order for its income to be free of tax. Or exemption may be enjoyed as a trust under 1954 IRC Section 642(a), which allows an unlimited deduction for charitable contributions that, pursuant to will or deed creating the trust, is paid or permanently set aside for exempt purposes, or that is to be used exclusively for exempt purposes.

Property can be held for charitable purposes only in trust or under a state or Federal charter. The possibilities of incorporation depend, of course, on local state law, but there seem to be no states in which there are general limitations on the incorporation of charities.[11] In New York, incorporation is possible under either the Membership Corporation Act or the Religious Corporation Act. The procedure is roughly the same as for incorporation of a business, with "members" taking the place of shareholders.

Charitable trusts are a recognized common-law type that exists in nearly all states. There are various common-law criteria as to what constitutes a charitable purpose, but they are easily complied with. New York and several other states have eliminated the old common-law distinction between executed and unexecuted trusts, or at least substituted their own definition of what constitutes an active or valid trust.

Essentially, New York law requires that certain specific duties be given the trustee in order for title to remain in him. For example, giving him the power to collect rents and profits from the property given in trust will be sufficient. There seem to be no cases holding charitable trusts invalid for failure to comply with the active trust definition. Trusts for educational purposes are given special consideration and need not meet the usual active trust requirements in order to be valid. Trusts that do not qualify as active become powers in trust to the extent that valid powers are given to the trustee, with legal title remaining in the grantor. This is not important, however, since it is too clumsy a form within which to work.

There is general agreement that it makes little appreciable difference whether the corporate or trust form is used. Of 287 foundations studied by Russell Sage, 78 per cent were incorporated, 32 per cent under New York law. One, the Research Corporation, had originally been a business corporation, but by amending its charter became a membership one. The reason for incorporation would seem to be first, that the trust is more hedged in by legal restrictions than the corporation, and, second, that the corporate form is more familiar to those who set up foundations.

Articles of Incorporation
of
The Ford Foundation

These Articles of Incorporation are signed and acknowledged by the incorporators for the purpose of forming a non-profit corporation known as a Foundation under the provisions of Act No. 327 of the Public Acts of 1931, known as the Michigan General Corporation Act, as follows:

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[11] *Home Oil Mill, et al.* v. *Willingham,* D.C.N.D. Ala., 2-24-49.

ARTICLE I.

The name of this corporation is THE FORD FOUNDATION.

ARTICLE II.

The purpose or purposes of this corporation are as follows:

To receive and administer funds for *scientific, educational, and charitable purposes, all for the public welfare,* and for no other purposes, and to that end to take and hold, by bequest, devise, gift, purchase, or lease, either absolutely or in trust for such objects and purposes or any of them, any property, real, personal, or mixed, without limitation as to amount or value, except such limitations, if any, as may be imposed by law; to sell, convey, and dispose of any such property and to invest and re-invest the principal thereof, and to deal with and expend the income therefrom for any of the before mentioned purposes, without limitation, except such limitations, if any, as may be contained in the instrument under which such property is received; to receive any property, real, personal, or mixed, in trust, under the terms of any will, deed of trust, or other trust instrument for the foregoing purposes or any of them (but for no other purposes), and in administering the same to carry out the directions and exercise the powers contained in the trust instrument under which the property is received, including the expenditure of the principal, as well as the income, for one or more of such purposes, if authorized or directed in the trust instrument under which it is received; to receive, take title to, hold, and use the proceeds and income of stocks, bonds, obligations, or other securities of any corporation or corporations, domestic or foreign, but only for the foregoing purposes, or some of them; and, in general, to exercise any, all and every power for which a non-profit corporation known as a Foundation, organized under the provisions of the Michigan General Corporation Act for scientific, educational, and charitable purposes, all for the public welfare, can be authorized to exercise, but not any other power. No part of the activities of this corporation shall be the carrying on of propaganda or otherwise attempting to influence legislation.

ARTICLE III.

The location of the corporation is in the City of Detroit, in the County of Wayne, and State of Michigan. The post-office address of registered office in Michigan is 2612 Buhl Building, Detroit 26, Michigan.

ARTICLE IV.

Said corporation is organized on a non-stock basis. The amount of assets which said corporation possesses is: Real property, NONE; personal property, TWENTY-FIVE THOUSAND DOLLARS cash. Said corporation is to be financed under the following general plan: By contributions to it of funds and property absolutely or in trust for its purposes as herein stated and for no other purpose.

ARTICLE V.

The names and places of residence, or business, of each of the incorporators, are as follows:

EDSEL B. FORD	Grosse Pointe Shores, Michigan
BURT J. CRAIG	19595 Canterbury Road, Detroit, Mich.
CLIFFORD B. LONGLEY	440 University Place, Grosse Pointe, Michigan

ARTICLE VI.

The names and addresses of the first named Board of Trustees are as follows:

EDSEL B. FORD	Grosse Pointe Shores, Michigan
BURT J. CRAIG	19595 Canterbury Road, Detroit, Mich.
CLIFFORD B. LONGLEY	440 University Place, Grosse Pointe, Michigan

ARTICLE VII.

This being a benevolent corporation, its term is unlimited and in perpetuity.

ARTICLE VIII.

Additional members may be admitted to this corporation at any meeting of its members, upon the vote, or written assent incorporated in the minutes of the meeting, of not less than two-thirds of its existing members, or by the Board of Trustees with the written assent incorporated in the minutes of the meeting of the Board of not less than two-thirds of all the existing members, provided, however, that there shall never at any time be more than nine members. Membership or any interest in this corporation shall not be assignable inter vivos by any member, nor shall membership or any interest in this corporation pass to any personal representative, heir, or devisee. Membership of any member shall cease upon his death or resignation, or upon adoption at a meeting of members of a resolution assented to by the vote, or written assent incorporated in the minutes of the meeting, of not less than two-thirds of all of the members, not less than ten days' notice of intent to present such resolution to the meeting for action having first been given to all members either personally or by mailing to their respective last addresses appearing in the records of the corporation.

ARTICLE IX.

All of the property of this corporation and accumulations thereof shall be held and administered to effectuate its purposes and to serve the general welfare of the people.

IN WITNESS WHEREOF the incorporators have signed these Articles of incorporation this 13th day of January A.D. 1936.

EDSEL B. FORD (*Sgd.*)
BURT J. CRAIG (*Sgd.*)
CLIFFORD B. LONGLEY (*Sgd.*)

STATE OF MICHIGAN }
COUNTY OF WAYNE } SS

On this 13th day of January A.D. 1936, before me a Notary Public in and for said County, personally appeared EDSEL B. FORD, BURT J. CRAIG, and CLIFFORD B. LONGLEY, to me known to be the persons named in and who executed the foregoing instrument, and severally acknowledged that they executed the same freely and for the intents and purposes therein mentioned.

MAXWELL V. WALLACE (*Sgd.*)
Notary Public
My Commission expires January 7, 1939

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How to Take Advantage of Sections 1301-4

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Progressive surtax rates cause a premium to be placed on the regularity of receipt of income. With tax rates unchanged, a taxpayer having an income of $200,000 over a ten-year period will pay a lower aggregate tax if the income is received in equal annual amounts than if $50,000 is received in one year, $5,000 in a second year and so on. Of course, the results might be different if the tax rates were varied during the period under consideration. Sections 1301-4 provide for an optional method of computing the tax on certain types of bunched income, in order to offset the effect of progressive surtax rates. These sections correspond to the subsections of former Section 107 in which only a few changes have been made. Unless a change is specifically noted hereafter, the rule under the prior statute was the same as under the current law.

1. Points to Consider

The taxpayer will, of course, use the optional method only if it results in a tax savings. He computes his tax in the usual manner for the tax year in question, with and without the "bunched" income. The difference is the additional tax caused by the receipt of the bunched income. The bunched income must then be allocated over a longer period and the additional tax caused by that income must be computed in accordance with Sections 1301-4. Whichever method yields the smaller additional tax should be utilized.

In order to make the required determination, the taxpayer must know:

	Section
What type of income is covered by Sections 1301-4 ("bunched" income)?	2, 3
When must the income be received?	5
How is the income allocated to prior years?	6
How is the additional tax on the allocated income computed?	8

Under each of these general questions, numerous specific problems are included, and these must be resolved before Sections 1301-4 may be applied properly. These problems concern

	Section
What is the kind of services for which the compensation must be received?	2
What is the cause for the delay in payment of the compensation?	3

	Section
How to determine the unit of services and compensation?	4
When do the services begin and end?	4
The required continuity of the work	4
What is the amount of bunched compensation which must be received in the tax year?	5
What is the relationship of the tax year to the period during which the services were rendered?	5
What is the length of the period during which the services were performed?	6
What is the effect of §§ 1301-4 on deductions and exemptions of prior years?	7
What is the effect of §§ 1301-4 on deductions and exemptions of the tax year in question?	7

In planning transactions to obtain the advantage of Section 1301-4, the taxpayer must take into account:

	Section
The relationship of the times when a purchaser of the services is found and when the work is performed	2
Who must perform the services?	2
What if there are changes in identity of parties?	2, 4
How to draft contracts	4
The timing of the commencement of one transaction with relation to that of other transactions	4

2. What Type of Income Falls Within Sections 1301-4?

The first three of these four sections each covers a different type of income and provides for different computations:

Section	*Subsection*	*Covers Income from*
1301	(a)	personal services
1302	(b)	a literary, musical or artistic composition of an individual taxpayer, or a copyright, or a patent for an invention of an individual taxpayer
1303	(d)	wages, salaries, retirement pay or similar compensation as employee; payments resulting from an alleged violation of a State or Federal law relating to labor standards or practices.

In order for the bunched income to constitute income from the required services or from a copyright or patent, the payer must intend that the payment be for the services, or for use of the copyright or patent, etc.,[1] and the payee must receive it for the same purpose.[2] Thus, if an inventor forms a corporation, and exchanges his patents for all of the stock of the corporation, the dividends declared on the stock are not income from the patent.[3] It is true that the taxpayer would not receive the income if it were not for his invention and patent. However, the corporation pays the dividend to the taxpayer because he is a stockholder, not because of the invention or patent. This is clear because a purchaser of part of the taxpayer's stock would receive the same dividends, as would other stockholders if there were any.

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[1] *Jack Rosenzweig,* 1 T.C. 24 (1942); *Doyle J. Dixon,* 16 T.C. 1016 (1951); D. G. *Haley,* 16 T.C. 1462 (1951).

[2] *Sovik* v. *Shaughnessy* (2d Cir. 1951), 191 F. 2d 895.

[3] *Steckel* v. *Commissioner* (6 Cir. 1944) 154 F. 2d 4, 34 AFTR 1078. If the taxpayer exploits the patent by manufacturing the patent item as an individual, he must be able to allocate the proceeds to the manufacturing operation and to the patent. *Alfred W. Barber,* 19 T.C. No. 95 (1953).

A payer may intend to pay for personal services, but if the payment is made to an assignee of the person who performed the services, the assignee may not receive the benefit of § 1301.[4]

Payments designated as salaries may at times fail to qualify as either salaries or as compensation for personal services. When corporations attempt to obtain deductions for the purpose of reducing corporate income taxes, they may designate payments to stockholder-officers as salaries rather than as dividends. If such deductions are disallowed to the corporation, the payments will fail to qualify under Section 1303 for the recipient since they were determined not to have been paid for services.[5]

Under 1301, it is not sufficient that the payer intended the payment to be compensation for personal services. The taxpayer must have performed the services with a view to fulfilling a deal.[6] This does not mean that there must be a firm contract with definite terms before any services are performed or that one contract cannot be replaced with another between the same parties[7] or that additional parties may not be added.[8] Thus, work may be performed for a corporation before it is organized by arrangement with its promoters.[9] But the taxpayer cannot perform some work entirely on his own and then find someone willing to pay for it. This requirement, clear as it was under the old 107, is made even more patent under 1301 which requires that the services be performed pursuant to an "employment." A taxpayer who performs services without an express agreement for compensation may later experience difficulty in proving that subsequently received compensation related back to the earlier services.[10]

The taxpayer's intent is also a factor under 1303, since the taxpayer must have performed his services as an employee[11] or must have received the payment as a result of an alleged violation of a Federal or state law relating to labor standards or practices. However, no such requirement of taxpayer's intent exists under 1302. The taxpayer may have created his musical, literary or artistic composition, or obtained his copyright patent before having any glimmer of the deal by which the income was received.

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[4] See note 2, *supra.*

[5] See Gordon, "The Scope of Subsections 107(a) and (b)," *Tax Law Review,* 1949, Vol. 4, page 169.

[6] *Paul J. Toner,* 2 T.C.M. 1101 (1943), par. 43536 Prentice-Hall Memorandum T.C. (1943). But see *Sloane* v. *Commissioner* (6 Cir. 1951), 188 F. 2d 254, 262.

[7] *E. A. Terrell,* 14 T.C. 572 (1950); *Frederico Stallforth,* 6 T.C. (1946); *Thomas D. Geoghegan,* 2 T.C.M. 122 (1943), par. 43,242 Prentice-Hall Memorandum T.C. (1943), cf. *Jesse L. Terry,* par. 49,232 Prentice-Hall Memorandum T.C. Dec. (1949).

[8] *McClelland* v. *Busey* (S.D. Ohio 1952), 105 F. Supp. 598; *Early* v. *Heath* (4 Cir. 1948), 170 F. 2d 70.

[9] *Guy C. Myers,* 11 T.C. 447 (1948).

[10] *Lucilla Whitman,* 12 T.C. 324 (1949), aff'd. (2d Cir. 1949) 178 F. 2d 913; *Gordon Wayman* 14 T.C. 1267 (1950).

[11] *Frank R. Bavis,* 18 T.C. 418 (1953), aff'd. (3rd Cir. 1953) 202 F. 2d 843.

When the income is received as the result of a lawsuit, the nature of the action must be carefully examined to determine whether the income is covered by sections 1301-4. A dispute concerning the amount due for such items as personal services and royalties on a patent would not prevent the sum recovered from being compensation for those items.[12] Even where the plaintiff claims a sum due for compensation or royalties and the defendant denies having entered into a transaction, any sum recovered by the plaintiff would qualify as income from the services, copyright, patent, and so forth, which were the basis of the suit. This follows from the fact that the court found that the plaintiff had intended and agreed to make the payment for the services, or use of the copyright, or patent, and so forth, even though the defendant denied it. However, Sections 1301-4 do not become applicable merely because the plaintiff prevails. If a taxpayer has entered into a contract to perform personal services for a designated price and the other party refuses to permit him to perform, the plaintiff will recover damages for breach of contract. But the sum recovered will not be compensation for personal services.[13]

Subsection 1301(b)(1), (formerly 107 (d)(2)(A)) applies to wages, salaries, retirement pay and other similar compensation. Since the purpose of this subsection is to afford relief when payment is delayed for reasons beyond the control of the employee, a system of compensation based on a share of the employer's profits will not be subject to the provisions of this subsection.[14] A taxpayer may come within these provisions, however, if his compensation is based on the sales volume, even though the amount of the employer's profit may be utilized to limit the maximum compensation paid.[15] The latter rule serves to relax considerably the former one which excludes straight percentage-of-profit schemes.

A payment received as a result of an alleged violation of a State or Federal law relating to labor standards or practices falls within the scope of subsection 1301(b)(3). It is believed that this provision covers statutory law only, and not the common law.[16] The principal statutes under it are the Fair Labor Standards Act,[17] as amended, under which overtime pay, minimum wages and liquidated damages may be received,[18] the National Labor Relations Act, as amended,[19] under which payments may be received as a result of the commission of unfair labor practices, and the Walsh-Healy[20] and Davis-Bacon Acts[21] which also regulate wage rates. Payments under similar State statutes receive the same treatment as do those under the Federal statutes. Income received as a result of a breach of contract would not qualify unless the breach constituted an unfair labor practice under a State or Federal labor relations act.[22]

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[12] *Weldon D. Smith,* 17 T.C. 135 (1951); *Bertha Kirkpatrick,* 3 T.C.M. 1312 (1944), par. 49,403. Prentice-Hall Memorandum T.C. (1949).

[13] *Est. of Stearns* v. *Comm'r.* (6 Cir. 1951), 189 F. 2d 259 aff'g. per cur. 14 T.C. 420 (1950). See Gordon, *op. cit.*, footnote 5, page 188-189; cf. *Mathey* v. *Comm'r.* (1 Cir. 1949), 177 F. 2d 259.

[14] *Norbert J. Kenny,* 4 T.C. 750 (1945).

[15] *James Newton Dean,* 10 T.C. 672 (1948).

[16] See Gordon, page 190 *op. cit.*, footnote 5.

[17] 29 U.S.C., § 201-262 (1952).

[18] It is believed that attorney fees recoverable under the Act are not includible in "back pay." See Gordon, *op. cit.*, footnote 5, page 187.

[19] 29 U.S.C. § 101 et seq. (1952).

[20] 41 U.S.C. § 35-45 (1952).

[21] 40 U.S.C. § 276a et seq. (1952).

Must the services be performed personally by the taxpayer? Subsection 107(a) expressly permitted a partner to apply Section 107 to his share of partnership income from personal services even though that partner performed no part of the services and, so it has been held, even though he was not a member of the partnership when the services were performed.[23] Other situations are also recognized in which subsection 107(a) may be applied to income received where another person performed the required services. In community-property states a spouse may obtain the benefits of the subsection for the personal services of the other spouse.

These rules continue unchanged under Section 1301, with one exception: in the case of services performed by a partnership, the partner must have been a member of the firm continuously for 36 months, or for all of the shorter employment period, immediately preceding receipt or accrual of the 1301 compensation.

Subsections 107(b) and 107(d) made no express provision for persons other than the taxpayer who performed the work. Nevertheless, they may be extended to the same classes of persons to which subsection 107(a) has been extended by express provision and as a result of the Congressional intent revealed in the legislative history,[24] *viz.* partners, and spouses in community-property states.[25] These rules apply as well under Sections 1302 and 1303.

Sections 1301-4 apply only to ordinary income. If the income in question is taxable as a long-term capital gain, the benefits of these sections cannot be obtained. This is likely to arise only under section 1302 as applied to the sale of patents. Prior to the Revenue Act of 1950, it could also apply to the sale of compositions and copyrights, but that act removed those sales from possible capital gains treatment.

3. What Must Have Caused the Delay in Payment?

Under sections 1301 and 1302, an agreement between the taxpayer and the payer as to date of payment is a permissible delaying event. This does not mean that, where the taxpayer may receive payment whenever he desires, he may still obtain the benefits of these sections. For example, a taxpayer who permits an open account for personal services to accumulate cannot obtain the benefits of section 1301 unless the accumulation is due to the inability of the client or customer to pay.[26] But whenever the taxpayer is delayed in receiving his income by an agreement calling for payment on a designated date or upon the happening of a contingency, the cause of the delay is acceptable under these subsections.

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[22] See footnote 16, above. For a situation in which a breach of a collective agreement was held not to constitute an unfair labor practice see General Counsel's ruling, Case No. 377, September 12, 1952, 30 L.R.R.M. 1408 (1952). For the contrary situation, see *Calif. Portland Cement Co.*, 101 N.L.R.B. No. 232, 31 L.R.R.M. 1220 (1952).

[23] *Commissioner* v. *Nielson* (9 Cir. 1951), 187 F. 2d 233; GCM 26,993, 1951-2 C.B. 54.

[24] Sen. Rept. No. 1631, 77th Cong. 2d Sess. 109 (1942).

[25] *Langer's Est.* v. *Comm'r.* (9 Cir. 1952), 194 F. 2d 288, aff'g. per cur. 16 T.C. 41 (1951); for facts see 13 T.C. 419 (1949), rev'd. (9 Cir. 1950) 183 F. 2d 738.

[26] *Jarman* v. *Jones* (WD Okla. 1949), 84 F. Supp. 184; *Julia C. Nast*, 7 T.C. 432 (1946).

Far more stringent standards apply to Section 1303. Where the payments result from alleged violations of Federal or State laws relating to labor standards or practices, the delaying event will in some cases be the alleged violation. In others, there will be no delaying event because, in the absence of the alleged violation, there would have been no payment.

Wages and salaries received or accrued this year by an employee for services performed earlier are back pay, if they constitute retroactive increases approved by a Federal or State agency. Originally orders of World War II agencies such as the National War Labor Board and the Salary Stabilization Unit of the Treasury were intended to qualify under this provision. Orders of their Korean War counterparts, the Wage Stabilization Board and the Office of Salary Stabilization served the same function. It may still be applied to retroactive increases awarded in arbitration. Where an arbitration is a special proceeding of the State court, the award alone should suffice. In other States, a judgment should be obtained confirming the award. Conciliation and mediation services in a wage dispute are not sufficient to qualify the payment received in the ensuing settlement as "back pay" within the meaning of the statute. Thus far, receivers and trustees awarded fees for past services by Federal or State courts have not succeeded in securing the benefit of this provision on the grounds that an agreement or legal liability must exist prior to the payment,[27] and that such persons are not employees.[28] Only the latter ground appears to be sound.

Other proper delaying events are: (1) bankruptcy or receivership of employer; (2) a dispute as to liability of the employer, determined after the commencement of court proceedings; (3) lack of funds on the part of an employer which is a governmental body or an agency thereof; or (4) any similar event as determined by the Treasury. The regulations under 1939 IRC § 107(d) provided only that the delaying event must have been an unusual one similar to the three above which causes a delay in the year of payment.[29]

Similar to the first classification are cases in which the employer's critical financial condition[30] or legal restrictions upon the use of the employer's assets[31] or internment of the employee by the enemy during wartime[32] caused the delay, even though no legal restriction upon the right of the employer to make payment existed.[33] There must have been, however, a prior agreement or liability to pay an ascertainable compensation during some prior year.[34]

A dispute concerning liability resolved after the commencement of an arbitration would be similar to the second classification,[35] as would a settlement following the retaining of an attorney to bring suit.[36]

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[27] *Cowan* v. *Henslee,* 84 F. Supp. 813 (D.C., M.D., Tenn., 1949), aff'd (6 Cir. 1950) 180 F. 2d 73.

[28] *James D. Moore,* par. 49,066 Prentice-Hall Memorandum T.C. (1949).

[29] Reg. 118, § 39.107-3(b).

[30] *Norbert J. Kenny,* 4 T.C. 750 (1945); *Langer's Estate* v. *Comm'r.* (9 Cir. 1950), 183 F. 2d 758.

[31] *Frederick H. Hagner,* 14 T.C. 643 (1950).

[32] Letter ruling dated November 30, 1945, signed by Commissioner Joseph D. Nunan, Jr., par. 7825A. Prentice-Hall Federal Tax Service (1953).

[33] *Langer's Est.* v. *Comm'r.* (9 Cir. 1950) 183 F. 2d 738.

[34] *David Glickman,* par. 54,144 Prentice-Hall Memorandum T.C. (1951); *United States* v. *Borton,* par. 72,491 Prentice-Hall Federal Tax Service (1950); *Elsie L. Sedlack,* 17 T.C. 791 (1951); *Frank R. Bavis,* 18 T.C. 418 (1953), aff'd. (3 Cir. 1953) 202 F. 2d 843. Contra: *Frederick H. Hagner,* 14 T.C. 643 (1950).

The normal fixing of a trustee's or receiver's fee at the close of his services is not an event similar to that of the third classification.[37]

If a payment is delayed "in accordance with the usual practice or custom of the employer" it does not come within the "back pay" classification.[38] Thus, salesmen's commissions or bonuses usually paid after the year of services would not be delayed within the meaning of Section 1303. Retirement pay is normally paid after the year of services. It is not "back pay" unless its payment is delayed after the scheduled date for one of the reasons specified above.

A taxpayer who could have obtained his wages, salaries, retirement pay, or similar compensation in an earlier year but failed to exercise his right would probably not be able to claim the benefits of Section 1303.[39]

4. How Is a Unit of Services and of Compensation Determined?

The applicability of Section 1303 depends upon the percentage which all of the "back pay" received during the year bears to gross compensation. Hence the problem of how to determine units of services and of compensation does not arise.

Under 1302 the unit is the literary, musical, or artistic composition, or the copyright or patent. Although some difficulty may arise in determining whether specified work was part of a unit, the trouble here is the ascertainment of the dates on which the work commenced and on which it was completed.

This difficulty also exists under 1301. In addition, the issue, whether compensation received from particular personal services should be treated together or separately to determine the applicability of the section, may reach serious proportions.

The ascertainment of the commencement and termination dates of the taxpayer's work is the first problem. Section 1301 (see Section 2 of this chapter) requires that the personal services be performed pursuant to a deal, or, in the language of the present law, pursuant to "an employment." Until a deal (however informal) is made, there can be no commencement date. The promoter of a plan cannot include in the period of his services the work involved in interesting financial sponsors in his plan. What happens if those backers decide to have the plan carried out by a corporation which they will form and which will compensate the promoter? Here the deal can date from the commencement of the arrangement between the promoter and the financial sponsors since they can assure the corporation's ratifying the deal.[40] Since a composition, patent, or copyright need not be made or obtained pursuant to a deal, these statements do not apply to 1302.

The commencement of the services under Section 107 had to be work of some objective nature: thinking about the problems did not do.[41] But it could consist of conferences, negotiations, or a search for customers if that is what the deal called for.[42] These must be distinguished from a search for someone with whom to make a deal. Success or failure in achieving results is not a material element. It suffices that the work was done at the request of the customer, client or employer.[43] Some record should, of course, be kept of the first services done after the request was received. The same rules apply under Section 1301 except that "study time" is deemed to be work if the compensation specifically covers study time.[44]

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[35] See *Thomas Thompson*, 18 T.C. 742, 745 (1952).

[36] *Thompson* v. *Comm'r.* (4th Cir. 1953), 203 F. 2d 820, rev'g. 18 T.C. 742 (1952); *Dingwell* v. *Comm'r.* (2d Cir. 1954), 211 F. 2d 921, rev'g. par. 52,247 Prentice-Hall Memorandum T.C. (1952).

[37] *James D. Moore*, par. 49,066 Prentice-Hall Memorandum T.C. (1949).

[38] H. R. Rep. No. 1079, 78th Cong. 2d Sess. 44 (1943). See footnote 29, above.

[39] See Gordon, pages 191-192 *op. cit.*, footnote 5.

[40] See footnote 9, above.

The rules that determine the commencement of the services are also applicable to the termination date. One additional point should be made. Just waiting for payment does not extend the period of services.[45] Of course, there may be cases in which the services of the taxpayer were secured to obtain a payment. Then the services would terminate when the payment was obtained. But if the services consist of promoting a business venture, suing for compensation is not part of the services for which the compensation is obtained.

Sometimes compensation is received by virtue of some relationship such as a partner or a spouse in a community property state. For the tax years prior to 1941, the taxpayer cannot include in the period of service, any services performed prior to the establishment of a partnership between the taxpayer and the person who actually performed the services.[46] It has been held that for tax years after 1941, it is only necessary that a partnership relation exist when the income is received, and that the period of service may include time preceding the date on which the relationship was established.[47] With respect to income received or accrued after March 1, 1954, the taxpayer must have been a member of the firm continuously for 36 months, or for all of the period of the employment (if shorter), immediately preceding the receipt or accrual of the 1301 income.

Only the commencement and termination dates of the services are significant. No services need be performed in between those dates. But the greater the period in which no services are performed, the more difficult it will be to establish the commencement or termination date. For example, some minor acts were performed on February 15, 1942, and nothing further was done until November 3, 1942. The taxpayer performed continually from November 3, 1942 to July 1945. The taxpayer will have great difficulty in establishing that February 15, 1942, rather than November 3, 1942, was the commencement date. The Treasury will require that the taxpayer clearly prove the commencement of the deal before February 15, and that work then was done pursuant to the deal. Proof of the performance on that date will also be made more stringent. On the other hand, the task of the taxpayer would be easier if additional services also were performed on, for example, March 8, 1942, March 23-25, 1942, and July 16, 1942.

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[41] See *Jean De Marco*, 9 T.C. 1188 (1947); but see *Edwin H. Blum*, par. 52,186 Prentice-Hall Memorandum T.C. (1952).

[42] *James D. Gordon*, 10 T.C. 772 (1948) affirmed (2 Cir. 1949) 172 F. 2d 864. But see *Frederico Stallforth*, 6 T.C. 140 (1946).

[43] *James D. Gordon*, 10 T.C. 772 (1948) aff'd. (2 Cir. 1949) 172 F. 2d 864, *Frederico Stallforth*, 6 T.C. 140 (1946).

[44] S. Rpt. 1622, 83d Cong., 2d Sess. p. 446 (1954).

[45] *Thomas D. Geoghegan*, 2 T.C.M. 122 (1943), par. 43,243 Prentice-Hall Memorandum T.C. (1943). But see *Frederico Stallforth*, 6 T.C. 140 (1946).

[46] *Ralph G. Lindstrom*, 3 T.C. 686 (1944) aff'd. (9 Cir. 1945) 149 F. 2d 344; G.C.M. 25795, 1948-2 C.B. 61. See *John Bell Keeble, Jr.*, 2 T.C. 1249, 1250 (1953).

[47] *Elder W. Marshall*, 14 T.C. 12 (1950), aff'd. (3 Cir. 1950) 185 F. 2d 674; *Burnham Enersen*, par. 50,024 Prentice-Hall Memorandum T.C. (1950), aff'd. (9 Cir. 1951) 187 F. 2d 233.

Our next problem is to distinguish one unit of services from another. Under 1302, this is easy, since a composition, copyright, or patent is a distinguishable unit. Difficulties may arise when the taxpayer uses specified work in one composition or invention and then uses it again in another. Even if the first composition or invention is abandoned, or fails to produce income, the second work cannot be dated back to the first because of the re-use of some of the material or ideas of the first.[48] However, the mere abandonment of some early work on a particular project does not require the use of a later commencement date.[49]

Sometimes the taxpayer has performed the second work pursuant to a deal. The nature, terms, and history of the deal will help in determining whether the taxpayer intended that the work be part of the second composition or invention at the time he performed the work. Where the second work consists merely of the original composition adapted to a new medium, it appears likely that the two will be treated as one unit. For example, the author of a book may have to do additional work to convert the book into a movie script or to serialize it. Yet, these are essentially one piece of work.[50]

More difficult is distinguishing between units of personal services. A taxpayer who performs a series of jobs for the same person may assure himself of the separability of each job and of its compensation by executing a different contract for each.[51] This requires that he know in advance the terms and specifications of each job. If the taxpayer agrees to perform services on projects obtained by another under some profit-sharing basis, separate contracts cannot be drawn in advance, for the subject matter involves mere expectations of business. Under these circumstances, the taxpayer must be content to enter into separate contracts when the business is obtained or to have all the projects and the compensation treated as a unit.[52] The former alternative involves the insecurity of leaving the other party in the arrangement free to demand new terms or to refuse to continue at all.

Where an employee commences work at a specified salary and later undertakes additional duties for further pay, the two sets of duties and their compensation will be treated as separate units.[53] But if the taxpayer agrees in one contract to perform specified services, these services are not separate units because the compensation consists of several components, each computed in a different manner.[54]

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[48] *Jean De Marco*, 9 T.C. 1188 (1947).

[49] *Iliff D. Richardson*, 14 T.C. 547 (1950).

[50] *Iliff D. Richardson*, 14 T.C. 547, 551 (1950).

[51] *Thomas D. Geoghegan*, 2 T.C.M. 122 (1943), par. 43,243 Prentice-Hall Memorandum T.C. (1943); *Byron C. Hanna*, 4 T.C.M. 36 (1945), par. 45,014 Prentice-Hall Memorandum T.C. (1945), aff'd. without discussing point (9 Cir. 1946), 156 F. 2d 135; see *J. Mackay Spears*, 7 T.C. 1271, 1275 (1946).

[52] *J. Mackay Spears*, 7 T.C. 1271 (1946) aff'd. (3 Cir. 1947) 164 F. 2d 486, 30 AFTR 429 (alternative); *Eugene J. Phillips*, 5 T.C.M. 1025 (1946), par. 46,279 Prentice-Hall Memorandum T.C. (1946).

[53] *E. A. Terrell*, 14 T.C. 572 (1950); *D. C. Slee*, 2 T.C.M. 437 (1943), par. 43,331 Prentice-Hall Memorandum T.C. (1943); *Bertha Kirkpatrick*, 3 T.C.M. 1312 (1944), par. 44,403 Prentice-Hall Memorandum T.C. (1944).

[54] *Harry Civiletti*, 3 T.C. 1247 (1944), aff'd. (2 Cir. 1945) 152 F. 2d 332, 34 AFTR 590

What happens when a taxpayer performs a single service but receives compensation from two different sources? Previously under these circumstances, the Court of Appeals held the two to be separate units,[55] but the Tax Court held to the contrary,[56] and the latter position has been expressly written into subsection 1301(b). The taxpayer should mold his transactions as one or more deals depending upon the number of compensation units he desires to create. Situations may arise in which services are initially performed as one unit, but are later performed as several units for different persons as a result of a change in the arrangement or in the artistic work; or invention may be commenced as one unit and become two. Can the later history of the transaction be carried back to treat the initial services or work as two or more units? In a case involving personal services, the Tax Court held in the affirmative,[57] but in a case involving an artistic work, it ruled negatively.[58] Since there is nothing in the language of the subsections involved to justify the difference in results, the issue is unresolved, although the language of the present statute tips the balance in favor of finding a single unit.

5. How Much Bunched Compensation Must Be Received During the Tax Year?

The rules under each of the sections differ with respect to

1. the percentage which must be received during the tax year of the income realized from the services producing the bunched compensation;
2. the percentage of income during the tax year which must consist of bunched income;
3. the percentage which must be received in a *single* tax year of income arising from services producing the bunched compensation.

Under 1301, 80 per cent of the total compensation from a unit of personal services must be received in a single year which must be the tax year. It is immaterial how long prior to the payment the services have been commenced, or how long after the payment they have continued. However, as will be pointed out below, the tax advantage will generally be greater as more of the period of services precedes the payment.

Example: The taxpayer agrees to perform specified services over a period of four years.

1. The total compensation is $100,000. $10,000 is received the first year, $10,000 the second year, $70,000 the third (and tax) year, and $10,000 is received the fourth year. Section 1301 is not applicable.
2. The total compensation is $100,000. $10,000 is received the first year, $80,000 the second (and tax) year, and $5,000 is received during each of the next two years. Section 1301 is applicable.

(alternative), cert. den. 327 U.S. 804 (1946); *Paul H. Smart*, 4 T.C. 846 (1945), aff'd. (2 Cir. 1945) 152 F. 2d 333, 34 AFTR 591, cert. den. 327 U.S. 804 (1946); *Harry Boverman*, 10 T.C. 476 (1948); *Carragan* v. *Commissioner* (2d Cir. 1952), 197 F. 2d 246.

[55] See *Heath* v. *Early* (E.D., Va., 1948), 77 F. Supp. 474, 36 AFTR 1519 aff'd. (4 Cir. 1948) 170 F. 2d 70; Cf. *Est. of Huddleston*, par. 49,032 Prentice-Hall Memorandum T.C. (1949).

[56] *George J. Hoffman, Jr.*, 11 T.C. 1057 (1948).

[57] *Guy C. Myers*, 11 T.C. 447 (1948).

[58] *Jean De Marco*, 9 T.C. 1188 (1947).

3. The total compensation initially agreed upon is $100,000. $10,000 is received the first year, and $80,000 the second (and tax) year. Nothing is received the third year, but during the fourth year, $50,000 is received as a result of a modification in the arrangement. Section 1301 will probably not be applicable.

Under 1302, of the compensation received from any one composition or invention, the taxpayer must receive during the tax year 80 per cent of all the compensation received up to the close of the year following the tax year. This is not 80 per cent of the total compensation received from that composition or invention.

Example: The taxpayer receives a total compensation of $300,000 from one composition or invention over a period of six years.

1. The following amounts are received:

Year	Amount
1	$ 10,000
2	50,000
3	.....
4	10,000
5	210,000
6	20,000

Section 1302 is applicable only to the payment received during the second year.

2. The following amounts are received:

Year	Amount
1	$ 1,000
2	30,000
3	2,000
4	10,000
5	240,000
6	17,000

Section 1302 is applicable to the second and fifth years.

3. The following amounts are received:

Year	Amount
1	$ 11,000
2	30,000
3	10,000
4	5,000
5	237,000
6	7,000

Section 1302 is not applicable to any payment.

There is no requirement under 1303 that the back pay received during the tax year constitute any particular percentage of the compensation received for the services from which the back pay arises. Nor is there any limitation on the number of years during which the taxpayer may receive the compensation of which the back pay is a portion. On the other hand neither 1301 nor 1302 contains any requirement as to the ratio which the bunched income received during the tax year must bear to the total income received that year. Under 1303, the back pay received during the tax year must constitute at least 15 per cent of the total income received during the year. In all cases, it is correct to use gross income figures without regard to any applicable deductions in making computations, although the cases are confused on this point.[59]

If the taxpayer operates an individual business, his total income for the year will include net receipts (sales) less cost of goods sold, but if he is a member of a partnership or joint venture, only his distributable share of net profit will be included.[60]

6. How Is the Bunched Income Allocated?

A minimum of 36 months of personal services expended on one unit of work is required in order to make 107(a) or (b) applicable. The period remains 36 months under 1301, but it is reduced to 24 months under 1302. In making time computations, periods of more than half a month are treated as full months and smaller fractions are disregarded.[61]

In computing the tax under these sections, the compensation is allocated ratably over the preceding months of work even though the services were not performed ratably during those months. The period over which the income is spread may be smaller than the period of work for a number of reasons.

First, the income can only be prorated over the period starting with the commencement of work and preceding receipt of the income. The compensation need not be received at or after completion of the work. It may be received while the work is being performed. Then the compensation cannot be allocated to the period between its receipt and the completion of the work.

Second, a partner who receives or accrues 1301-4 income after March 31, 1954 may only spread such income over the period during which he has been a partner, even though the period during which the work was performed was longer. One exception to this rule exists if the partner is entitled to the benefit of these Sections by virtue of the length of his partnership, he may spread the income back before the partnership commenced to an immediately preceding period during which he was an employee of the partnership, but not earlier than the commencement of the work.

Third, under 107(b), the period over which the compensation may be allocated is limited to a maximum of 36 months immediately preceding the close of the tax year in which the payment is received.[62] If the composition or invention requires a longer period to complete, the part exceeding 36 months before the close of the tax year gives no benefit. Under 1302, the period preceding the close of the tax year has been enlarged to 60 months in the case of inventions only.

Under 1303, no minimum period of work is required. As long as the receipt of the income is delayed for the proper cause, the benefit of this subsection is obtained. The statute expressly authorizes the Commissioner with the approval of the Secretary of the Treasury to issue regulations governing the allocation. While no regulations have as yet been issued under the new Code, there is no reason to expect any change since the statute remains unaltered in this area.

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[59] Use gross compensation: *Weldon D. Smith*, 17 T.C. 135 (1951); *William J. Cusick*, 3 T.C. M. 1324 (1944) par. 44,408 Prentice-Hall Memorandum T.C. (1944). Use net compensation: *Leland J. Allen*, 5 T.C. par. 1232 (1945); *Bertha Kirkpatrick*, 3 T.C.M. 1312 (1944) par. 44,403 Prentice-Hall Memorandum T.C. (1944).

[60] *Langer's Est.* v. *Comm'r.* (9 Cir. 1952), aff'g. per cur., 16 T.C. 41 (1951).

[61] IRC § 1304(a) (formerly § 107(c)).

[62] *Robertson* v. *United States,* 343 U.S. 711 (1952).

The compensation for back pay under 1303(b)(1) (formerly 107(d)(2)(A)) shall be allocated[63] to the year in which it would have been received had the delaying event not intervened. Similarly in the case of a retroactive wage or salary increase under 1303(b)(2) (formerly 107(d)(2)(B)), the compensation shall be allocated to the year it would have been received had the increase become effective on the date to which it had been made retroactive. If the back pay consists of a payment received as the result of the violation of a Federal or State law under 1303(b)(3) (formerly 107(d)(2)(C)) the payment is allocated to prior years to the extent that the payment was received for an alleged violation that occurred in or continued during that prior year.

Sometimes a Federal or State agency or court, which has awarded or passed on the amount of back pay, attributes that back pay or some portion of it to a particular period of time or that may be done in a settlement agreement.[64] Then that allocation is accepted as the appropriate apportionment. If none of these rules on the allocation of back pay is applicable, then the back pay is attributed ratably to each of the particular months included within the entire period for which the back pay was received.

This rule is far more severe than that for 1301 and 1302. Under these sections, the compensation is allocated ratably over the entire period of work from its commencement until the compensation is received (subject to the limitations described above). This is true even though the work may have been performed entirely within two months: the month it was commenced, and the month it was completed, with no work performed in the intervening months. Under the back pay allocation, the only eligible months are those in respect to which the back pay was received.

7. How Does the Operation of Sections 1301-4 Affect Deductions and Exemptions?

Certain deductions as charitable contributions and medical expenses are subject to limitations based upon the taxpayer's adjusted gross income during the year the deduction is sought. An increase in adjusted gross income will increase the permissible deduction for charitable contributions,[65] but will decrease the maximum deduction for medical expenses.[66] If the income allocated to prior years pursuant to Sections 1301-4 were to affect the adjusted gross income of the prior years, a recomputation of the taxes for the prior years would be required. Unfortunately, the authorities dealing with this problem are in conflict.

The better view is that income allocated to prior years under Sections 1301-4 remains income of the taxable year in which it was received or accrued, and does not become income of the prior years. Therefore, deductions, computed on the basis of income received during the tax years to which Sections 1301-4 income is allocated, should be unaffected by the allocation. One case has held, however, that, in computing the medical deduction for the year in which Section 107 income was received, only that portion of the Section 107 income allocated to the year of receipt could be considered,[67] and this view has been applied by the Treasury to charitable deductions as well.[68] Since the same principle controls all the deductions and exemptions computed as percentages of gross income, this case would require recomputations of all past returns covering years to which Sections 1301-4 income is allocated if such deductions had been claimed.

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[63] Reg. 118, § 39.107-3(d)(1).

[64] *Weldon D. Smith*, 17 T.C. 135 (1951).

[65] IRC § 170(b) (formerly § 23(o)).

[66] IRC § 213 (formerly § 23(x)).

The same principle applies to exclusions from gross income under Section 911 (formerly 116(a)), which exempts earned income from sources outside the United States from the gross income of a taxpayer who has been a resident of a foreign country during the entire taxable year. The exclusion of Sections 1301-4 income should rest upon the facts present in the taxable year and not the year to which the income is allocated.[69] Similarly, in computing a net operating loss for the tax year to be carried back, the loss is reduced by all 1301-4 income received during the tax year including the portion allocated to prior years[70] and, in determining whether 25 per cent of gross income has been omitted for the purpose of applying the five year statute of limitations, all income as to which the taxpayer claims the benefit of §§ 1301-4 is deemed to have been included in reported gross income.[71]

Other decisions in favor of complete recomputations have been rendered under subsections 6(a) and (b) of the Current Tax Payment Act. The taxpayer was required by these subsections to pay only the greater of the taxes for the years 1942 and 1943, plus one-fourth of the lesser tax. It has been held that any Section 107 income which was allocated to 1942 and 1943, was also subject to the forgiveness feature.[72]

A word of caution should be added. Even though it be held that the allocation of Sections 1301-4 income of prior years does not, in general, lead to a recomputation of net income, such a recomputation may be made even after the statute of limitations has run to correct for under-reported income or for excess deductions.

As a general rule, expenses incurred in connection with the work from which the Sections 1301-4 income arises continues to be deductible in the year paid if the taxpayer is on a cash basis or the year accrued if the taxpayer is on an accrual basis. Special treatment may be had only where the delay in the receipt of the income also delays the payment of the expense. For example, where the taxpayer agrees to pay for expenses in connection with the work out of which the Sections 1301-4 income arise, a percentage of that income, then the delay in receiving the income causes a delay in the payment of expenses. The result may be that a large sum of accumulated expenses may be paid in one year. If that sum were deductible only from the income received that year, after deducting therefrom the Sections 1301-4 income allocable to prior years, the income figure would be distorted. This result is avoided in the case where the expense is payable as a percentage of the Sections 1301-4 income, by allocating the expense to prior years in the same manner as the Sections 1301-4 income is allocated.[73]

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[67] *Edward C. Thayer,* 12 T.C. 795 (1949).

[68] I.R. Mim. No. 43, 4 P-H Fed. Tax Serv. par. 76,321 (1953).

[69] *Frederico Stallforth,* 6 T.C. 140 (1946).

[70] *Albert G. Redpath,* 19 T.C. 470 (1952).

[71] *Maurice H. Van Bergh,* 18 T.C. 518 (1952).

[72] *William F. Knox,* 10 T.C. 550 (1948); *Arthur T. Schmidt,* 10 T.C. 746 (1948).

8. Final Computation of the Tax

For each year prior to the taxable year to which 1301-4 income is allocated, the allocated income is added to the net income for that year and the additional tax is computed. Of course, if there has been a prior allocation of 107 or 1301-4 income to that year, the prior allocation must be included in the net income figure with which we commence the computations.[74] The taxpayer must be able to prove the amount of income received in the prior year.[75] If a joint return was filed in the year to which an allocation is made of income received or occurs prior to March 31, 1954, the taxpayer must compute the additional tax for that year on a joint basis and may not recompute the tax on an individual return basis.[76] Allocations to prior years of income received or accrued after March 1, 1954 must be treated or included in the separate return of the individual who would otherwise be required to include it in his separate return in the year of receipt or accrual.[77] The legislative history indicates that the provision was designed to bar the computation of tax in earlier years as though joint returns had been filed where, in fact, they had not.

For the current taxable year, the tax will be computed in the normal manner, after excluding the 1301-4 income allocated to prior years. Then, to the tax for the current year is added all the increments in taxes computed on the Sections 1301-4 income allocated to prior years. The resulting total is the tax for the current year if Sections 1301-4 are applied. The taxpayer must also compute his tax for the current year in the normal manner including in gross income all of the Sections 1301-4 income. He is then obligated to pay the lesser of the two figures.

If a joint return is filed under § 6013(a) (formerly § 51(b)) for a tax year in which 107 income is received, the tax under § 2 (formerly § 12(d)) will be twice the tax on one-half of the income. This affords a spouse in a non-community property state, the same advantage as to § 107 or §§ 1301-4 income received or accrued prior to March 31, 1954 which had previously been enjoyed only in community property states. And this advantage exists even though such income is allocated to years in which income splitting was not available.[78] Income received or accrued after March 31, 1954 may only be allocated back for computational purposes to the individual return of a person who would be required to include such income in his individual return in the year of receipt or accrual.

If the taxpayer has received several different items of Sections 1301-4 income in one tax year, he may find it advisable to apply those sections to some of the items and not to others. This alternative is also available to him.[79]

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[73] I.T. 3773, 1945 C.B. 151.

[74] Reg. 118, § 39.107-1(h).

[75] *Walter J. Gresham,* P-H T.C. Memo. Dec. par. 49,016 (1949).

[76] *George K. Ford,* 18 T.C. 387 (1952).

[77] IRC § 1304(c) and (d).

[78] *Hofferbert* v. *Marshall,* 200 F. 2d 648 (4th Cir. 1952).

Sections 1301-4 are applied without regard to the tax on self-employment income and does not affect that tax.

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[79] *Guy C. Myers*, 12 T.C. 648 (1949).

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Making Deals for Insurance Income

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The many uses for life insurance, endowment and annuity contracts in business as well as personal affairs has given rise to new and frequently unanticipated income tax problems. Because of the uniqueness of the life insurance contract, the solution to a particular tax problem may require a preliminary understanding of the contract itself.[1] Moreover, the life insurance policy transaction will frequently raise tax questions that, in and of themselves, are not solely insurance tax questions but invoke application of various sections of the Internal Revenue Code wholly unrelated to life insurance matters as such.

1. Points to Consider

Assume your client is contemplating some changes in his personal insurance program. This may apply to planning his insurance for his own retirement, for his beneficiaries in the event of his death, or perhaps for some business use. A discussion of the possible income tax questions applicable thereto will be found as follows:

	Section
How to handle maturing endowment policies	3
Selecting mode of settlement for your beneficiary	4
Should your beneficiary pay off policy loans	5
Selection of best installment option	6
Change or revision of your existing policies	7
$5,000 income tax exemption for deceased employee's beneficiary	17

Before you assign or transfer an insurance policy on your life you should examine the potential income tax liability involved in such a transfer.[2] There are some exceptions to the rule imposing income tax on transfers for a valuable consideration that were not available under prior law. However, the contemplated transfer may be impractical when the income tax liability is taken into consideration. The important points are discussed in the following sections:

	Section
General discussion	8
Policies involved in divorce	16

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[1] The Life Insurance Policy Contract, Little, Brown and Company; MacLean on Life Insurance, 6th Edition.

[2] IRC § 101(a)(2).

2. Points in Business Insurance Planning

You may be contemplating the purchase of new insurance in connection with a proposed business transaction or using some already issued personal insurance or business insurance in a proposed transaction. The income tax questions pertaining to such uses are many, the more important of which will be found in the following sections:

	Section
Transfer of policy to a business associate	8
The "transfer for value" rule	8
Policies transferred under postponement of gain or loss deal	8
Loans to purchase insurance and annuities	9
Corporation owned insurance (to be used to buy stock from estate)	10
Life insurance to fund Stock Purchase Plan (Corporate redemption vs. individual plan)	11
Partnership purchase agreements effective at death	12
Annuities purchased by corporation for officers	13
Insurance on employees, owned by Corporation	14
Debtor paying insurance premiums	15
Creditor paying insurance premiums	15

3. Tax at Maturity or upon Surrender of Policies

The annual increase in the cash value of a life insurance, endowment, or annuity policy is not taxed to you from year to year because the increment in value is not considered as actually or constructively received.

When your endowment policy matures, any gain (measured by excess of maturity value over premium cost) will be taxed[3] as ordinary income;[4] the gain can be spread over three years,[5] taking into consideration the year of maturity and the two years prior thereto. This relief will be some consolation to those who believe that the gain should be capital gain rather than ordinary income.

You can avoid paying on this gain by electing to take the proceeds on an installment basis payable for a fixed period of years or for a year's certain period and life thereafter. You must make that election within sixty (60) days after the date of maturity.[6]

You cannot avoid tax liability on the gain when a policy matures simply by electing the "interest only" option.[7] Election of this option is not sufficient to avoid constructive receipt. Election of any annuity option not later than sixty days after the maturity date, however, avoids tax liability on the gain at maturity.

The 1954 Code makes no distinction between an installment option for a term of years and one that guarantees payment for life[8] for purposes of determining the income tax liability from year to year as the installments are paid to the insured. The so-called 3% rule has been completely abandoned, and certainly not prematurely, for purposes of taxing annuities. Under the 1954 Code, where the annuity is for life, the purchase price of the annuity is divided by the life expectancy of the annuitant (pursuant to tables set forth in Regulations) and the excess received annually is taxable income.[9] The exclusion is constant and remains the same over the annuitant's lifetime. If the annuity is for a fixed period of time, rather than for life, the purchase price of the annuity is divided by the number of years the annuity is to be paid, rather than by the annuitant's life expectancy, and the quotient is the allowable annual exclusion.

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[3] *Blum* v. *Higgins*, 150 F. 2d 471, aff'g 57 F. Supp. 140; *Farren*, BTA Memo, 5-30-42.

[4] IRC § 72(e)(1).

[5] IRC § 72(e)(3).

[6] IRC § 72(h).

[7] See Footnote 3, supra.

[8] IRC § 72(a).

4. Death Proceeds Exempt from Income Tax

Unless the insurance proceeds paid at your death are received by a transferee of the policy for which value had been paid not coming within an exception, they are entirely exempt from income tax.[10] This exemption applies whether the proceeds are paid to an individual, trust, partnership or corporation.[11] This is the rule if the proceeds are paid out, rather than held by the insurance company under some installment option.

In cases where the proceeds are held by the insurance company after the insured's death and paid in installments, the interest element contained in the payments is gross income to the beneficiary.[12] The procedure is to prorate the sum of the entire death proceeds over the period of the income settlement which gives the annual exclusion from gross income. The excess received each year is gross income to the recipient, except where a surviving spouse is the beneficiary which gives rise to a limited exemption. For example, the insured's spouse can receive $1,000 a year above the excluded sums without incurring income tax liability. This specific exemption would indicate that at least some portion of an insured's insurance might well be placed under an income option to take advantage of this exclusion.

If the proceeds are held by the insurance company under an "interest only" option the income is taxable in its entirety. Under this type of option only interest is paid out, with all the capital being retained on deposit.[13]

5. Beneficiary Paying Off Loans at Your Death

Some insurance companies will permit the beneficiary to repay policy loans after the insured's death. If the policies are perhaps pre-1940, or older, they may contain very favorable income settlement options when compared to more current issues which would be desirable to utilize. Consequently, the repayment of the loan is then considered as part of the death proceeds for purposes of placing under income settlement options.[14] Where the beneficiary is the insured's spouse, there would also be an income tax advantage because of the annual exclusion of

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[9] IRC § 72(b).
[10] IRC § 101(a).
[11] Reg. 111, § 29.22(b)(1)-1.
[12] IRC § 101(d).
[13] IRC § 101(c).
[14] *Grace R. Maxson Hall,* 12 T.C. 419.

$1,000 for amounts received under an income settlement option, assuming that there was not enough other insurance to fully utilize this specific exclusion.

6. Selecting Options for Your Beneficiary

You should examine very carefully all of your life insurance to see which policies provide the best rates of guaranteed interest and also the most favorable guaranteed stipulated payments under the various options of settlement for your beneficiary. Usually the pre-1940 policies provide better guaranteed rates of interest under the income options than those issued thereafter. You will find it advantageous to use the newer policies for lump sum settlements and the older ones for income purposes.

7. Exchange of Policies

There are three types of exchanges of insurance policies under the 1954 Code where no gain or loss will be recognized. These are described below. The taxpayer was subjected to taxable income by Internal Service Ruling[15] where a single premium ten year endowment policy was surrendered under one of its options upon maturity of the policy, for a cash withdrawal plus a fully paid-up life policy. The taxable income constituted the sum of cash plus the value of the paid-up policy minus the net cost of the surrendered ten year endowment policy. Apparently, this ruling will still apply under the 1954 Code.

The three exceptions heretofore mentioned are as follows:[16]

1. a contract of life insurance for another contract of life insurance or for an endowment or annuity contract; or
2. a contract of endowment insurance (A) for another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or (B) for an annuity contract; or
3. an annuity contract for an annuity contract.

The Code then goes on to define what is meant by an Endowment contract, Annuity contract and Life insurance contract.[17]

It will be observed that all three exceptions are potential transactions where the cash reserves in the surrendered policy are likely to be approximately the same or less than the cash reserves in the newly acquired policy received in exchange.

8. Policies Assigned for Valuable Consideration

The exemption from income tax of insurance proceeds payable as a result of the death of the insured, does not apply where you have assigned the policy for a valuable consideration.[18] In the latter instance, the proceeds are income less deductions for the consideration paid for the assignment, plus premiums paid by the transferee subsequent to the assignment. If you make a gift transfer of the policy, the "transfer for value" rule does not apply. However, if you transfer a policy to a business associate, even though no *cash* consideration is involved, it may likely be regarded as a transfer for value. The business relationship will probably be used for purposes of attaching some value. Any such contemplated transfer should first be submitted for expert opinion before consummation.

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[15] Rev. Ruling. 54-264, IRB. 1954-30, 8, July 26, 1954.

[16] IRC § 1035.

[17] IRC § 1035.

[18] See Footnote 2, supra.

You cannot escape the transfer-for-value rule by using term insurance without cash values, or policies that have been borrowed upon to the maximum. A life insurance policy has an economic value sufficient to support the transfer-for-value rule even though it has no cash value.[19] This is not an unreasonable conclusion because if the term policy has no value, the transferee would not seek to acquire it.

Fortunately, the 1954 Code now gives rise to some new exceptions to the transfer-for-value rule which should prove of inestimable value.[20] Prior to the 1954 Code, the only statutory and Treasury approved exceptions constituted a situation where the insured reacquired a policy on his own life which previously had been owned by another person or entity, and also in a transaction where the transferred assets took the same basis in the hands of the transferee as in the hands of the transferor at the time of the transfer. In other words, a reorganization transaction where gain or loss is postponed by statute. These two exceptions remain in the 1954 Code. In addition, these important exceptions were added:

1. to a partner of the insured;
2. to a partnership in which the insured is a partner;
3. to a corporation in which the insured is a shareholder or officer.

Various questions immediately present themselves in connection with the three foregoing newly enacted exceptions. For example, partners can transfer policies among themselves without tax exposure, but why does not the same privilege extend to shareholders in a corporation? Moreover, the tax exposure does not arise where an insured transfers a policy to a corporation in which he is a shareholder or officer; apparently, owning one share of any class of stock would be adequate to come within the exception, and being elected a vice-president would also be adequate. It is likely that the law contemplates a situation where the insured is connected with management but it does not so state. In many states the corporation does not need to have an insurable interest in the insured to acquire an already issued policy, but it would have to show an insurable interest to acquire the policy in the first instance.

If your corporation owns a policy on your life that you want your wife to now own, do not transfer the policy directly to her.[21] It should first be transferred to the insured and then the insured could make a gift assignment of the policy to his wife. This type of transaction may be used to some degree now, since the premium payment test was removed for taxing the insurance in the insured's estate at death.

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[19] *Spokane Dry Goods Company*, T.C. Memo, 4-19-43; *James F. Waters, Inc.* v. *Comm.* 160 F. 2d 596, affirming T.C. Memo, 1945.

[20] IRC § 101(a)(2)(B).

[21] *Hacker*, 37 B.T.A. 659.

In one case, a stockholder received insurance on the life of a co-stockholder upon liquidation of the corporation as a liquidating asset. The policy possessed no cash values. However, it was regarded as a transfer for value.[22]

If you and your business associates own more than one corporation, and the identity of all stockholders in the two or more corporations is the same, you can transfer a policy *directly* from one corporation to the other and escape the transfer-for-value rule.[23]

It has been held that the erroneous use of a transfer form with the usual clause, "for one dollar and other valuable consideration," does not constitute valuable consideration if the transaction was actually by way of gift, or if there actually was no consideration involved in the transfer. Furthermore, if you took out a policy for corporate ownership purposes and assigned the policy to the corporation simultaneously with issuance of the policy and paid the first and subsequent premiums with the corporation's check, the transfer-for-value rule would not apply. This latter situation has arisen frequently where the corporation failed to apply for the insurance on a corporate-ownership application in the first instance, but on the contrary, the insured made the application with an assignment over to the corporation.[24]

The income subject to tax under the transfer-for-value rule is treated as ordinary income. It has been suggested, however, that this gain is capital gain and not ordinary income. There are no cases directly on the subject. However, it seems that any gain realized should come under the capital gain limitations as with any other capital asset sold or exchanged by the taxpayer.[25]

9. Loans to Purchase Insurance or Annuities

In 1942, the law was amended denying a deduction for interest paid on a loan used to purchase single premium life insurance or endowment policies.[26] A single premium policy was defined in the law as any policy on which substantially all the premiums are paid within a period of four years from the date on which the contract is purchased. Some doubt would seem to exist as to whether this definition would include a case where the insured prepaid the premiums (as contrasted to a policy of the single premium variety). However, under the 1954 Code all doubt is removed. A single premium policy is clearly defined as one where a substantial number of future premiums are paid on the contract by means of deposits with the insurance company.

Moreover, denial of an interest deduction for borrowed money is also carried over to the purchase of annuities under the 1954 Code.[27] The law states— No deduction shall be allowed for— Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

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[22] *Lambeth, Chas.*, 38 B.T.A. 351.

[23] *Haverty Realty & Investment Co.*, 3 T.C. 161.

[24] Informal letter ruling of Deputy Comm'r.

[25] It would appear that any gain realized in connection with an insurance policy transferred for a valuable consideration should constitute capital gain just as in the case of any other capital asset sold or exchanged by the taxpayer. However, there is no direct authority to support this conclusion.

In one case, the transfer of a policy created a capital gain, but apparently the proceeds had lost their identity as "insurance proceeds" as they were being held on deposit following the death of the insured. It is not clear whether the same conclusion would have been reached had the policy been transferred prior to the insured's death. *Jules J. Reingold*, B.T.A. Memo, 1941, P-H Memo Service, 41,319.

[26] 1939 IRC § 24(a)(6).

Apparently, the inclusion of single premium annuities under the 1954 Code was prompted by the practice of some insurance companies of selling annuities with a loan to cover most of the premium cost.

The new portion of the law applicable to prepayment of premiums and loans to purchase annuities is effective only as to transactions after March 1, 1954.

10. Income Tax Aspects of Corporation-Owned Insurance

If your corporation owns insurance on your life which is intended to help in providing cash to pay your death taxes through redemption of your shares or a part thereof, at your death, be sure that the situation qualifies under the newly expanded and advantageous section of the 1954 Code.[28] For example, such a redemption may possibly be regarded by the Internal Revenue Service as the receipt of a dividend by the executor of the estate and taxable as *ordinary income*, thus disregarding the purchase and sale aspects of the transaction. However, by complying with the new Code section, under proper advance planning the sums received by the estate from the corporation are *not* regarded as the receipt of income. On the contrary, they are treated as a distribution in full payment in exchange for the stock so redeemed.

This will enable many stockholders to cope with the "frozen estate" problem. Life insurance can be purchased by the corporation in an amount approximating the potential death tax liability including funeral and administration expenses. Thus, the corporation has the cash at just the right moment to buy enough shares from the estate to pull it out of the woods.

Of course, if the deceased stockholder through his representatives, or pursuant to contract entered into prior to his death, "bails out" completely and has no continuing interest thereafter, and if his close family relationships have no interest, then there is no income tax problem. However, in many situations, it is desired to sell only a part of the shares and retain some interest in the corporation for the family thereafter. That is when the problem arises which is remedied to a large degree by the new law.

Generally, to qualify under the new provisions, the stock must constitute 35 per cent of the gross estate or 50 per cent of the taxable estate. Thus, where the maximum marital deduction is used, the stock need be only ½ of the taxable portion of the estate (this could be about ¼th of the estate after deductions and the marital deduction). Moreover, the new Code was made more liberal in allowing a decedent to qualify if he owned stock in two or more corporations. The stock used in computing the extent to which it makes up the gross or taxable estate must be an interest in excess of 75 per cent of the outstanding shares. In other words, the deceased must have been a dominant shareholder in such corporations, if more than two.

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[27] IRC § 264(a)(2).
[28] IRC § 303(a).

One point bears watching under this new section. If a part of a deceased shareholder's stock is redeemed, it may put people in control other than the decedent's family, which they perhaps do not wish to permit.

It is to be noted that the values for federal estate tax purposes are going to be controlling. Subsequent valuation changes may work some tricks on your plans and the potential possibilities in this connection should be taken into consideration. Remember, that the stock must constitute at least 35 per cent of the gross estate or 50 per cent of the taxable estate which may shift if changes are made in the values for federal estate tax purposes.

11. Stock Purchase Plan Funded by Insurance

If you are a shareholder in a close corporation, the chances are you will want to have the contractual right to buy the shares owned by your co-stockholders in the event of their death. This would prevent the widows from coming into the business, as well as provide a market for the deceased shareholder's stock. On the other hand, if you have a son who is interested in the business, you may want to have him receive your shares at your death instead of co-stockholders.

The first question is whether you want to enter into such a so-called "buy and sell" agreement under an individual purchase type of contract with co-stockholders, or whether the corporation should purchase and redeem the decedent's shares at death.

Generally speaking, the simplest procedure from a legal and tax standpoint is an agreement leaving the corporation out, as such; it would not be a party to the buy and sell agreement. Thus, the co-stockholders would cross-purchase the insurance so that no one would own the policy on his own life. No corporate questions are involved in the individual purchase type of contract. If your co-stockholder dies, your cost (not for income tax purposes) is simply the premiums paid on his policy. However, if the corporation is to redeem the shares and thereby become a party to the buy and sell agreement, several questions should be checked.

First. Check your local law to see if corporations have the power to buy their own shares.[29] Attention should be paid to the enforceability of the contract. There must be "mutuality of obligation," of course, in order to constitute an enforceable agreement. If the corporation has the power to purchase its own shares only if it has surplus, it may not be able to perform under some circumstances. If the corporation has an *option* to buy its stock, or if the contract with the shareholders is predicated on an agreement of employment, there can be no serious questions as to its enforceability. Moreover, where a surplus is to be created by means of corporate-owned life insurance, it is likely that the *Topken* case[30] has little or no application.[31] Local law must be considered carefully when drafting a contract of this type with the corporation as a party.

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[29] In Indiana, corporations have the power to purchase shares of their own capital stock if and when the capital of the corporation is not thereby impaired. Burns, Indiana Statutes, 25-202(b)(8).

Second. The corporation's surplus account, because of the insurance cash values should be examined in the light of the 1954 Code provisions which, in the past were contained under Section 102. The new Code has liberalized the rules applicable to unreasonable accumulation of surplus. It is now described as "Accumulated Taxable Income." [32]

Third. The valuation clause set forth in the stock purchase agreement must be handled carefully because it is the heart of the agreement. The following points should be considered:

The cash value of the corporate-owned insurance increases systematically, thus increasing book-value which would be reflected in surplus. Therefore, if book-value is used as a valuation basis, the life insurance could defeat its original purpose, namely, to provide the purchase price for the decedent's stock. This can be prevented by stipulating an arbitrary value for each share of stock which would peg the value at some arbitrary point selected by the shareholders. Of course, this is inflexible and should be looked at frequently so that it could be kept in line with changes in the value of the business, and in addition, it is recommended that a "formula valuation clause" be inserted, designed to take over if the shareholders forget about revising the agreement in the future. This affords a sort of safety valve if the shareholders are negligent in keeping the arbitrary value up to date.

Fourth. Check to determine what effect the stock redemption will have upon the interests of surviving shareholders. It is possible that you are inadvertently converting a minority interest to a majority interest contrary to your wishes.

If life insurance proceeds payable at death furnish all or a part of the purchase price for a decedent's stock there is likely to be an increase in the value of the shares owned by the surviving shareholders so far as book value is concerned. This increment in value is not regarded as gross income.[33] Of course, it would be taken into account upon a subsequent sale of the shares where the sale price is augmented because the basis to the shareholder had not changed.

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[30] *Topken, Loring & Schwartz* v. *Schwartz*, 249 N.Y. 206, 163 N.E. 735. In this case, the court took the position that there was a lack of mutuality of obligation as between the parties and the contract was rendered unenforceable. It was reasoned that the corporation could perform only if it had surplus under New York law and the corporation could put itself in a position where it would be without surplus and thus relieve itself of its part of the contractual obligation.

[31] *Greater New York Carpet House, Inc.* v. *Herschmann*, 258 A.D. 649 (1940).

[32] IRC § 533.

[33] Where insurance proceeds flow to the corporation upon the death of a shareholder and are used to redeem the decedent's stock, the remaining shares outstanding show an increase in book value. (At least, this would be the result to the extent that the proceeds paid at death exceeded the cash values immediately prior to the insured's death.) There has been no sale or exchange with respect to the survivor's shares and hence no direct basis for taxing as income this increment in value. The case of *Fred Fischer*, T.C. Memo, 5/8/47, has erroneously been cited as a danger signal of the approach of this attitude by the I.R.S. In the *Fischer* case, corporate funds were paid to a retiring shareholder which included payment of some obligations outside the scope of corporate activities. Therefore, the portion of corporate funds used to discharge obligations regarded as personal rather than corporate, were regarded as tantamount to a dividend distribution for the benefit of the remaining shareholders and taxable to them.

Fifth. Under a properly arranged corporate stock retirement plan funded by life insurance, the policies are unconditionally owned and controlled by the corporation. The policy rights and values at all times constitute an asset of the business, even though lodged with a trustee. The policies would maintain a status comparable to any other asset of the business so far as creditors of the corporation are concerned.

The premiums paid by the corporation on the insurance are not treated as income to the insured-stockholders. In this connection, it is interesting to observe that the *Emeloid* case,[34] prior to its reversal, was held up by some as a warning that the premiums paid on insurance to be used under a stock purchase agreement would be taxed as gross income to the insureds individually. Under this tax theory, the insurance would be regarded as personal and not maintained for corporate purposes. Fortunately, as was predicted in this chapter prior to reversal of the case, the third Circuit reasoned that any plan designed to protect management from encroaching outsiders was a corporate purpose of predominant character.

It would seem only logical that if the premiums paid for insurance to be used for stock retirement purposes is to be taxed personally to the insured-shareholders, then under a similar plan not using insurance, the entire surplus ultimately to be used for purchase of the shares should be taxed to the shareholders from year to year. It obviously would be a ridiculous situation.

12. Partnership Purchase Agreements Funded by Life Insurance

If you are a partner you probably have entered into some type of agreement setting forth provisions applicable in the event of death. Such agreements should be carefully drawn, particularly with respect to the valuation provisions and the terms for payment. In many instances, life insurance is purchased to furnish the purchase price or a portion thereof. Of course, this is the most economical method for supplying the cash.

Rather recently, the so-called "entity plan" has been publicized as a sort of discovery in the field of partnership law for purposes of arranging a buy-and-sell agreement. Actually, there is nothing new about this method. There is no reason why the partnership cannot own insurance in much the same manner as it would take title to real property or any other asset. Where the agreement is properly drawn the partnership itself can purchase the interest of a deceased partner, using the insurance which it owned on the deceased partner's life. Under this method, the plan would be similar to a corporate stock retirement program. The advantage in the partnership owning the insurance is that where there are quite a few partners it is more convenient to have the partnership simply own one policy on each partner, rather than having a great many policies, as would be required under the so-called cross-purchase plan. It would also be possible to have a trustee *own* the policy in much the same manner as a trustee owns the insurance under a pension plan. With a properly drawn trust agreement, it could be worked out very similar to the partnership itself owning the insurance.

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[34] *Emeloid Co., Inc.*, 14 T.C. 295; reversed, 3rd Circuit, 189 F. 2d 230, 40 AFTR 674.

The agreement can also be arranged individually among the partners on a cross-purchase plan of the insurance, in contrast to the so-called entity plan where the partnership itself owns the insurance. Thus, you will own the policy on your partner and pay the premiums, and he will do likewise with respect to the policy on your life. The beneficiary can preferably be a trustee or, in the absence of a trustee, the owner of the policy can also be the beneficiary. The beneficiary would collect the proceeds in the event of the death of a partner and use them to pay the decedent's estate for the decedent's interest.

If you buy your parner's interest at his death, naturally you want your cost basis for income tax purposes to include any insurance proceeds used by you in making the purchase. Moreover, you also want to be sure that you are not restricted to using only premiums paid, rather than the full amount of the insurance proceeds in determining your basis.

If you use the cross-purchase plan and actually collect the proceeds at your partner's death, thereafter paying them over to your partner's estate, you are assured of the desired results so far as basis is concerned. If you use a trustee as the intermediary, you can show that you constructively received the proceeds which were used to buy out your partner, therefore entitling you to include the insurance proceeds in your basis.

In the *Legallet* case[35] a surviving partner was denied the right to include the insurance proceeds in his basis. In that case, however, each partner carried the insurance on his own life and they even went so far as to make the proceeds payable directly to the widow of the insured. It was held that the survivor did not actually or constructively receive the proceeds for purposes of determining the cost basis of the interest purchased from the deceased partner's estate. It is obvious that the *Legallet* case is of limited application because not many purchase agreements will be created under that procedure.

The problem of basis is more important than you may at first anticipate. If corporate stock is involved, upon subsequent disposal the gain will be a capital gain. In the partnership case, however, you will probably be purchasing inventory and upon disposal you will have ordinary income rather than capital gain (assuming you continue the business rather than liquidate subsequent to your partner's death).

There was one possible income tax disadvantage inherent in the cross-purchase plan before the 1954 Code, where there are more than two partners involved and the survivors are going to continue the business. For example, if A dies his estate will own policies on B and C. Thus, in order to continue with the cross-purchase plan after A's death, B would want to purchase the policy from A's estate on the life of C, and C would want to purchase the policy on B's life. This would run afoul of the transfer for value provisions under prior law and the surviving partners would encounter an income tax problem. Now, however, this transfer would come within one of the statutory exceptions to the rule.[36]

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[35] *Legallet*, 41 B.T.A. 294 (1940).

[36] IRC § 101(a)(2)(B).

13. Purchase of Annuities by Corporation for Officers

If your corporation does not maintain a qualified employees benefit plan, proceed with care in the purchase of annuities for officers with premiums paid by your corporation.[37] Usually, the officers will want to avoid the income tax in the current year with respect to the premiums paid for the annuity by your corporation. If any incident of ownership vests in the officer-employee either actually or constructively, he will be taxed on the premium payments in the year of purchase. This is true even though the annuities possess no cash or loan values and produce no benefits other than annuity payments postponed until some later year.

An employer purchased a single premium annuity for an employee in 1939 under which income payments were to commence approximately ten years later. The policy was retained by the employer. The employer could not assign the policy nor accelerate the income payments provisions. It was held that the employee had received some value in 1939; the realization of income was not postponed, although the taxable value was something less than the actual premium payment.[38]

The tax problem is simply postponed until the time comes for turning the annuities over to the officers. If the incidents of ownership in the annuity policy are delivered to the officer he will be taxed on the fair market value of the policy in the year of transfer to him (probably cost of purchasing identical benefits). Perhaps you can cause the insurance company to pay the annuity income directly to your corporation and you can in turn pay it over to the officer from your corporation. If all incidents of ownership remain in your corporation, it seems that the officer should be taxed only on the actual sums received and in the years actually received. Of course, then the officer's income is dependent on the corporation's continued solvency.

14. Corporation-Owned Insurance on Key Employees

Premiums paid by your corporation on policies owned on officers and/or other employees are non-deductible.[39] However, the proceeds paid at death are exempt from income tax. The exemption of the proceeds from income tax will be denied if the stockholders enter into an agreement between themselves authorizing the directors to promptly pay proceeds of policies when received as dividends on capital stock. The proceeds will be a taxable dividend.[40] The proceeds have been construed as "earnings or profits" for purposes of the 1939 Code, Section 115(g) in taxing the dividend.[41]

If your corporation owns the policy on your life and pays the premiums, it should also be named beneficiary. If you name your wife beneficiary, there is a hybrid situation where the corporation owns the policy and all the incidents of ownership, including cash surrender values, but, after your death, the corporation owns nothing, and your wife will collect the proceeds. It is difficult to predict the tax results under such circumstances.

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[37] Prentice-Hall Pension & Profit Sharing Service, par. 5331-2-3-4.

[38] *Drescher* v. *U.S.* 179 F. 2d 863.

[39] IRC § 264(a)(1).

[40] *Golden* v. *Commissioner*, 113 F. 2d 590, 25 AFTR 429; *Cummings* v. *Comm.*, 28 B.T.A. 1045, aff'd. by 1st Circ.

[41] See footnote 40, supra.

If your corporation owns the policy and your wife is named beneficiary, the premium payments will probably be taxed to you personally as either a dividend or additional salary. In order to be consistent, if the policy is for your family's benefit, the corporation should not own the policy but you should own it personally. The purpose of the insurance should be determined and then any hybrid situations should be avoided.

15. Insurance Carried by Creditor on Life of Debtor

If you are a debtor, you cannot take any income tax deduction for premiums paid for insurance on your life which you have assigned as collateral,[42] and if you are a creditor paying the premiums you cannot take a deduction except where you have no recourse for recovering such premiums.[43]

If you, as a creditor, collect the proceeds from a policy on the life of a debtor they will be gross income, because the policy was transferred for value. However, if your debt is uncollectible, it will offset any taxable proceeds. If you charged off a debt and then subsequently took an assignment for a policy from your debtor, having originally secured a tax benefit for the charge-off, you will have to report the proceeds as gross income when received.[44]

It seems that you can secure a tax advantage if you apply for new insurance on your debtor. You thus avoid assignment of the policy to you from the debtor. In one case, a corporation charged off a bad debt and then subsequently took out an insurance policy on the debtor's life. When the insured died, the corporation collected the insurance proceeds, income-tax free, although it had previously charged off the debt.[45]

16. Policies Involved in Divorce

The use of life insurance in connection with divorce and legal separations has become quite common. It serves purposes that cannot be reached with any other type of property. Consequently, the income tax results under various circumstances deserve careful consideration. Basically, if the insurance brings about some immediate benefit to the wife, the premiums paid by the husband will be treated as additional alimony and taxable to the wife and deductible by the husband. For example, policies irrevocably assigned to the wife constitute an immediate benefit and would fall into the foregoing described classification.

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[42] Deduction denied because taxpayer is regarded as a "direct or indirect" beneficiary. Sec. 264(a)(1), 1954 Code. *Rieck* v. *Heiner*, 25 F. 2d, 453, 6 AFTR 1540, cert. denied 277 U.S. 608; *Lynch*, B.T.A. Memo, 4/17/1941, par. 41,227 Prentice-Hall Memo B.T.A.; *Favorite Panama Hat Co.*, Tax Court Memo, June 7, 1943, par. 43,274 Prentice-Hall Memo T.C.

[43] G.C.M. 14375, XIV-1 C.B. 52; *Cadwalader*, 15 B.T.A. 1; *Dominion National Bank*, 26 B.T.A. 421; *First National Bank (Tulsa)* v. *Jones*, 53 F. Supp. 842, 32 AFTR 343, affirmed 143 F. 2d 652; *Est. of W. B. Thompson*, 42 B.T.A. 1477. Deduction denied where creditor was business partner of debtor, *Yarnall*, 9 T.C. 616.

[44] *St. Louis Refrigerating & Cold Storage Co.* v. *U.S.* 162 F. 2d 394, 35 AFTR 1477.

[45] *Durr Drug Company* v. *U.S.* 22 F. Supp. 788, 20 AFTR 1210, rvs'd, 99 F. 2d 757, 21 AFTR 1195.

If the insurance is simply additional security for the discharge of the husband's obligation, it is probably not regarded as an immediate benefit to the wife and such premium payments would not be considered as additional alimony. Furthermore, policies assigned to a child of the divorced parents would not give rise to an income tax deduction with respect to premium payments made by the husband.

17. Income Tax Exclusion for an Employee's Widow up to $5,000

A deceased employee's estate or beneficiaries can receive up to $5,000 tax exempt from the decedent's employer. This exclusion from gross income is set forth under the 1954 Code.[46] The payment apparently can be voluntary or pursuant to a contract between employer and employee. The exclusion does not apply if the right to receive was non-forfeitable. Apparently, this would rule out the first $5,000 paid out in renewals to a deceased insurance agent under the commission contract, because in most instances such payments would have become vested before death and therefore non-forfeitable.

The exclusion is obviously a decided advantage for officers of a corporation where the widow is apt to be in a high income tax bracket. However, partners probably could not qualify because they are not employees.

Where an employer contemplates paying the widow of an employee a sum up to $5,000 in order to take advantage of this tax benefit, it would be a good plan to underwrite the obligation with corporate-owned life insurance. The premiums paid on the insurance would not be deductible, but the proceeds paid to the corporation at death would be excluded from corporate income tax. Ultimately, when the corporation paid the widow $5,000, it would constitute an expense in the nature of compensation and qualify for an income tax deduction. Of course, the sums in the hands of the estate or widow would be income tax free. The plan is well worth considering.

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[46] IRC § 101(B)(1).

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How to Get Greatest Individual Deductions

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Foresight and careful planning and recording of expenditures by individual taxpayers may result in substantially increased deductions without an increase in the actual expenses. It is the purpose of this chapter to point out techniques by which this may be accomplished, with respect to certain deductions which are allowed by statute, irrespective of whether the individual is engaged in a trade or business. The specific deductions and their treatment are discussed as follows:

1. Points to Consider

Section

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2. What to Consider First About These Deductions

In considering the deductibility of any of the expenses discussed in this chapter, the following three points must first be given consideration:

a. Who may take the deduction? As a general rule, if you are liable for the expense and pay it, you are entitled to the deduction. Ordinarily, if an expense is paid by another, which would be deductible by you if you paid it, neither you nor your benefactor will get the deduction.[1] However, exceptions to the rule have been made in the following instances:

Payment by a corporation controlled by taxpayer, charged to his account.[2]

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[1] Prentice-Hall 1955 Federal Tax Service, par. 13,051, and cases cited therein.

[2] *George D. Mann*, 33 B.T.A. 281 (1935); *U.S.* v. *Collier* (5 Cir. 1939), 104 F. 2d 420; *Charles Goodman*, Par. 46,300 Prentice-Hall Memorandum T.C. (appeal dismissed, 176 F. 2d 389, (2 Cir. 1949) 38 AFTR 338).

Payment of interest on mortgage on property owned by taxpayer where he was not liable on bond or note.[3]

Payment to cooperative housing corporation of maintenance assessments to the extent that they include interest and real estate taxes.[4]

A further exception is where husband and wife file a joint return—they are then treated as a single taxable unit.[5] Thus, if the wife owns real property and the husband pays the taxes thereon, such taxes are allowable on a joint return.

b. When may the deduction be taken? The table below answers this question.

c. When should the standard deduction be used? In lieu of the specific deductions discussed in this Chapter (and contributions and alimony discussed elsewhere in this book), an individual may take the "standard deduction";[6] no substantiating details are required or necessary where this deduction is taken. If your adjusted gross income is $5,000 or more, the standard deduction is the lesser of (1) 10 per cent of adjusted gross income,[7] or (2) $1,000, except that for a married individual, filing a separate return, the amount is $500. Thus, for example, if your adjusted gross income is $12,000 and your detailed deductions for such items as taxes and interest total only $600, you may omit the listing of those deductions and take instead the standard deduction of $1,000.

DEDUCTION	TAKEN ON CASH BASIS WHEN:	TAKEN ON ACCRUAL BASIS WHEN:*	SEE SECTION OF	
			1939 CODE†	1954 CODE†
Interest	Paid	Incurred	23(b)	163
Taxes	Paid	Incurred	23(c)	164
Casualty Losses	Sustained‡	Sustained‡	23(e)	165
Medical and Dental Expenses	Paid	Paid	23(x)	213
Non-Trade and Non-Business Expenses	Paid	Incurred	23(a)(2)	212
Dependent Care Expenses	Paid	Paid	None Allowable	214

* The words "incur" and "accrue" are not synonymous; the former means "become liable to" and the latter means "to be added by ordered growth (by way of increase or decrease)." Thus, where the word "incurred" is used in this column, the expenses indicated may be *accrued* (added to deductions) when the *liability exists* (has been *"incurred"*).

† Also see 1954 IRC § 7701(a)(25); 1939 IRC § 48(c).

‡ 1954 IRC § 165(e) provides that losses from *theft* shall be considered as having been "sustained" in the year in which the theft is *discovered.*

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[3] Reg. 118, § 39.23(b)-1.

[4] 1954 IRC § 216; 1939 IRC § 23(z) (relating to cooperative *apartment* corporation only).

[5] *Helvering* v. *Janney,* 311 U.S. 189, 61 Sup. Ct. 241 (1940), 24 AFTR 1073; *Taft* v. *Helvering,* 311 U.S. 195, 61 Sup. Ct. 244 (1940), 24 AFTR 1076.

[6] 1954 IRC § 141-144; 1939 IRC § 23(aa). But when the standard deduction is used you may not take any credits for foreign taxes, for taxes withheld at source on tax-free covenant bonds, and for partially tax-exempt interest on obligations of the United States and its instrumentalities.

[7] 1954 IRC § 62; 1939 IRC § 22(n) (and note that under 1954 IRC § 62(2), (C) and (D), certain business expense deductions are allowed employees and outside salesmen, in arriving at "adjusted gross income").

If your adjusted gross income is *less* than $5,000 and you wish to take the standard deduction, you must use a Special Table.[8] Approximately 10 per cent deduction is given effect to in this table.

If you use the standard deduction and later find that your listed deductions would have been greater, or vice versa, you may elect to change your basis for claiming deductions at any time within the statutory period for filing claims for refund. But if you are married, and you and your spouse file separate returns, both must be on the same basis, and if one elects to change the method of taking deductions he may not do so unless the other similarly so elects.

3. What Interest is Deductible?

Interest on any indebtedness, whether business or personal, is deductible except on the following:

Loans incurred to purchase or carry tax-exempt securities,[9] and

Loans incurred or continued to purchase single premium life insurance or endowment contracts (including any such contracts where substantially all the premiums are paid in less than four years after purchase).[10] The 1954 Code[11] adds the disallowance of interest on loans incurred to purchase, after March 1, 1954, single-premium *annuity* contracts, and also defines a "single-premium" contract as any life insurance, endowment, or annuity contract, if an amount is deposited after March 1, 1954, with the insurer for payment of a "substantial" [12] number of future premiums on the contract.

A further exception applies to *accrual-basis taxpayers*.[13] Interest accrued on the following types of indebtedness is not deductible unless the creditor is also on the accrual basis and reports the income or unless it is paid within two and one-half months after close of the taxable year:

Between members of the same family,

Between a stockholder and a corporation in which he owns directly or indirectly through members of his family or his partners more than 50 per cent of the outstanding stock; also between two corporations where the same ownership conditions exist, if either of the corporations was a personal or foreign personal holding company,

Between a grantor and a fiduciary of a trust,

Between a beneficiary and a fiduciary of a trust,

Between fiduciaries, or beneficiaries and fiduciaries, of separate trusts created by the same grantor.

The 1954 Code added the following related taxpayers to the above;

Between a fiduciary of a trust and a corporation in which the trust or the grantor owns directly or indirectly through members of his family or his partners more than 50% of the outstanding stock,

Between a person and certain[14] charitable or similar organizations controlled [15] directly or indirectly by such person or (if the "person" is an individual) by members of his family.

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[8] 1954 IRC §§ 3, 4 and 36; 1939 IRC §§ 400-404.

[9] 1954 IRC § 265(2); 1939 IRC § 23(b).

[10] 1954 IRC § 264; 1939 IRC § 24(a)(6); Reg. 118 § 39.24(a)-5.

[11] 1954 IRC § 264.

[12] What is meant by "substantial" will probably be clarified by regulations to be issued.

[13] 1954 IRC § 267; 1939 IRC § 24(c).

[14] Those to which 1954 IRC § 501 relate.

[15] "Controlled" is not defined, but it can hardly mean stock ownership because most charitable foundations and like organizations are non-stock membership corporations. Perhaps regulations will point up direction or management as constituting "control."

In order to create a disallowance, however, all *three* of the following conditions must exist:[16] (1) the debtor and creditor must have different accounting methods, (2) the specified relationship between debtor and creditor must exist, and (3) the interest must remain unpaid 2½ months after the close of the taxable year.

If you pay this type of interest *more* than two and one-half months after the close of your taxable year, you *never* get the deduction.[17] If you borrow the money and pay up before the two and one-half month period, you get the deduction.

Interest paid to a cooperative apartment corporation (the 1954 Code enlarges this category by including cooperative "*housing*" corporations), to the extent of the tenant-stockholder's proportionate share, is considered as interest of the latter, even though paid to the corporation which in turn pays it to the mortgagee. (See Section 4, page 1467, relating to taxes.)

Cash-basis taxpayers may deduct only the amount of interest *actually paid* but payment is *not* made by the following methods:

Issuance of a note for the amount of such interest,[18]
Increase in the face amount of an existing note by the amount of the interest,[19]
Issuance of a new note to the same creditor for an amount greater than the preexisting note.[20]

If you do not have the cash but want the deduction, you will get it if you:

Borrow from another party and pay the interest with cash; repay by a later increase in the original loan,[21]
Make a new loan elsewhere for an amount sufficient to pay the old loan *and* the interest,[22]
Borrow on an insurance policy to pay a bank loan and interest or to pay the loan and interest on a policy loan with another insurance company.[23]

In this connection, remember that when loans are made by discounting notes, you get no interest deduction until the *full* amount of cash actually received by you is repaid.[24] For example, if you give a note for $600 for a year discounted at 6 per cent, you only receive $564. Only after the latter amount is fully paid do you receive an interest deduction. If you discount an *installment* note, however, (as opposed to a *term* note) you may deduct the aliquot portion of each payment which represents interest, whether such interest is added to the note or discounted from the note. In other words, if the note calls for monthly payments over a two-year period and the interest is $24.00 (either on a gross or discount basis), $1.00 of each monthly installment paid constitutes deductible interest.

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[16] *Michael Flynn Manufacturing Co.*, 3 T.C. 932 (1944).

[17] Reg. 118 § 39.24(c)-1.

[18] *Francis R. Hart*, 21 B.T.A. 1001 (1930); also *Eckert* v. *Commissioner* (2 Cir. 1930), 42 F. 2d 158, 8 AFTR 11067. The Court said, "The giving of a note does not constitute cash payment."

[19] *Arthur A. Beaudry*, par. 43,156 Prentice-Hall Memorandum T.C.

[20] *D. J. Donahue, Exec. Estate of Henry McGraw*, par. 34,512 Prentice-Hall Memorandum B.T.A. See also *S. E. Thomason*, 33 B.T.A. 576 (1935).

[21] This would not constitute substitution of one note for another which included interest due, as to which see footnote 19.

[22] See footnote 21.

[23] See footnote 21.

[24] *John C. Cleaver* (7 Cir. 1946), 158 F. 2d 342, 35 AFTR 517, affirming 6 T.C. 452 (1946).

Where installment *purchases* are made and carrying charges are separately stated but interest is *not*, the 1954 Code permits you (for years beginning after December 31, 1953) to deduct interest equal to the lesser of (a) the carrying charges attributable to your taxable year, or (b) 6 per cent of your average unpaid monthly balance for such year.[25]

Interest may be paid for past, current, or future use of the borrowed money.[26] Therefore, if you have had an exceptionally good year income-wise, consider paying up interest which has in the past been added to the principal of a previous loan (as for example, life insurance loans), paying your mortgage or other interest in advance for four or five years.[27]

Another way of increasing interest deductions may be open to you if you support a dependent owning real property. Say, for example, that you give an allowance of $2,500 per year to your parents, which is more than one-half of their support. They jointly own a home worth $20,000 with a $10,000 mortgage at 5 per cent, and pay $200 per year in real estate taxes. They receive jointly $60 per month in Federal old-age benefits[28] and have no other income.

You now get a tax benefit of $1,200 per year as credits for dependents and out of your $2,500 they have only $1,800 for themselves ($2,500 less $500 mortgage interest and $200 real estate taxes). But if you buy the home from them, taking title thereto and give them a 5 per cent second mortgage for their equity, you get the following credits and deductions:

Credit for dependents	$1,200.00
Mortgage interest (two mortgages)	1,000.00
Real Estate Taxes	200.00
	$2,400.00

You can decrease the *allowance* of $2,500 down to $1,300 (again assuming that that is more than 50 per cent of their support) and you will be paying them the same *net* cash ($1,300 plus $500 mortgage interest). Your outlay is still $2,500, but you now have deductions of $1,200 for interest and taxes, in addition to the dependency credit of $1,200.

If, in the above example, the dependents did not qualify as credits, you would *still* create tax deductions not otherwise allowable, to the extent of the interest and real estate taxes.

If you are supporting dependents who pay rent from your allowance, it might be equally well to consider buying a house for them to live in.[29] You could also create a tax saving in this way.

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[25] 1954 IRC § 163(b)(1) and (2).

[26] 1954 IRC § 163(a); 1939 IRC § 23(b) "All interest paid—within taxable year."

[27] I.T. 3740, 1945 C.B. 109.

[28] Old Age and Survivors Insurance benefits are not subject to Federal income tax. I.T. 3447, 1941-1 C.B. 191. Not being taxable income, therefore, such benefits are not counted in determining whether a dependent has more than $600.00 of "gross income." They must of course be counted in determining whether or not a taxpayer contributes more than 50% of the support of a dependent.

Accrual-basis taxpayers have far less opportunities for controlling interest deductions than do cash basis taxpayers. Interest is deductible as it accrues whether paid or not, except under the circumstances described at the beginning of this section.

The possibilities of purchasing property belonging to a dependent and increasing deductions by paying interest (and real estate taxes), discussed above under the "cash basis taxpayer" subheading, should be explored by accrual basis taxpayers also—the opportunities for tax-saving exist to the same extent.

4. What Taxes May Be Deducted?

Generally speaking, all taxes paid or incurred by the person against whom they are imposed are deductible except:

1. **Federal**—income, war profits or excess profits, estate, gift, employees' Federal Insurance Contributions Act, excise and stamp taxes and import duties;
2. **State**—estate, inheritance, legacy, succession or gift taxes;
3. **Local**—taxes assessed against local benefits of a kind tending to increase the value of the property assessed, except to the extent that they are allocable to maintenance or interest charges; the 1954 Code makes the further exception for taxes assessed by a special taxing district if (a) the district covers the whole of at least one county, (b) at least 1000 persons are subject to the district taxes, and (c) the assessment is levied annually at a uniform rate on the assessed values used for real property taxes;[30]
4. **Foreign or United States Possession**—income, war profits or excess profits taxes, if credit therefor is taken against your Federal income tax.

The exceptions to the rule that taxes are allowable only to the person against whom they are imposed are as follows:

1. Retail sales taxes on the sale of tangible personal property or services at retail, measured either by dollar-values or stated sums per unit, if they are separately stated and paid by the purchaser are deductible by him, even though they are actually levied against the seller.[31]
2. A tenant-stockholder in a cooperative apartment corporation (the 1954 Code enlarges this category by including cooperative "*housing*" corporations) may deduct his aliquot part of the real estate taxes paid or accrued to the corporation during the taxable year.[32]

Under the 1939 Code, as interpreted by the Courts, real estate taxes are deductible by the owner of property at the time the taxes become a lien on the property, or when the owner became personally liable for them. If you paid these taxes and the prior owner would have been entitled to deduction under these rules, you have only added to your purchase price. You get no deduction for them.[33] The 1954 Code,[34] however, specifically provides that, for sales made after 1953, real estate taxes for the "real property tax year" (the period covered by the regular assessment) *must* be apportioned between the seller and the buyer, irrespective of who paid, or is liable for, the taxes, or whether or not they have been paid at the time of sale; the seller deducts his proportion of the tax from the beginning of the "real property tax year" to the day *before* the sale, and the buyer deducts his proportion from the day *of* the sale to the end of such "tax year." This is the rule even though your contract of sale may provide for a different settlement of the taxes. Thus, if you sell a piece of real property on August 10 and, under the terms of your contract, you are required to pay all taxes then assessed, and the real property assessment year is July 1—June 30, you would pay a full year's taxes, but you could only deduct $^{40}/_{365}$ths.[35] of it (and presumably the balance would be added to your cost basis of the property); your purchaser could deduct $^{325}/_{365}$ths. If, under the terms of the contract your *purchaser* is required to pay the entire year's taxes immediately after he acquired the property, the deductions would remain unchanged (the proportion deductible by you would apparently become added cost of the property to the purchaser).

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[29] See *John Charles Thomas et al.*, par. 39,112 Prentice-Hall Memorandum B.T.A. Here, the taxpayer bought a home for his parents and *gave it to them*, thereafter either paying real estate taxes himself, or reimbursing his father when he paid them. His deduction for the taxes was denied.

[30] 1954 IRC § 164(b)(5).

[31] 1954 IRC § 164(c); 1939 IRC § 23(c)(3); Reg. 118 § 39.23(c)-1.

[32] 1954 IRC § 216; 1939 IRC § 23(z); Reg. 118 § 39.23(z)-1.

But suppose the purchaser pays the taxes in a taxable year *after* the year in which the sale took place? No deduction in the year of payment—they were apportionable and deductible in the year of sale.

Where the *seller* paid the taxes in a year *before* the year of sale the following rules apply:

a. If his deduction in the prior year is no more than the amount allocable to him at the time of the sale (this could be in a case where taxes are paid in installments, for example, or where the sale takes place on or about the end of the real property tax year), then his prior year's deduction stands, and he has no deduction in the year of sale.

b. If his deduction in the prior year was *greater* than his allocable proportion upon sale, he has realized income to the extent of the excess, and if the prior year's deduction resulted in a tax benefit he must include this excess as taxable income to the extent that he previously benefited taxwise.

c. If his payment was made prior to 1954 so that the 1939 Code applied, the apportionment rules of the 1954 Code do *not* apply.

A *cash-basis taxpayer* may deduct any allowable taxes paid in the taxable year, whether they be delinquent or current, so long as they are imposed against him and are either due or payable. Thus, in some communities it is possible to pay and deduct two years of real property taxes in one year. For example, assume that you have owned your home for more than a year and the taxes are *assessed* on, say,

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[33] *Adda, Inc.*, 9 T.C. 199 (1947), affirmed (2 Cir. 1949) 171 F. 2d 367; *Milner Hotels, Inc.*, T.C. Memo (1948), affirmed (6 Cir. 1949) 173 F. 2d 566; *Magruder* v. *Supplee* (1942), 316 U.S. 394, 62 Sup. Ct. 1162, 29 AFTR 196.

[34] 1954 IRC § 164(d).

[35] The numerator represents the number of days from the beginning of the real property tax year, July 1, to the day before the sale, August 9.

October 1, *payable* in semi-annual installments the following February 1 and August 1. You have paid the taxes assessed last year on the two installment dates this year. After October 1 but before December 31,[36] this year, when next year's taxes have been *assessed* you can pay the full taxes and get the deduction. Although not *due* they are *imposed* and *payable* because they have been assessed.

If you are subject to a state or local income tax you may also be able to pay and deduct two years of such taxes by filing your return on December 31 [37] and paying the tax then.[38] If you paid the tax this year, based on last year's income, you may deduct *both* taxes. State or local income taxes are, in general, self-assessed. You assess yourself when you file the return. These taxes are payable because the income on which they are based has been earned and is ordinarily determinable as of the last day of the year, even though payment may be delayed by statute until a later date.

Another point to remember is that state or local taxes withheld are deductible in the year so withheld even though the withholding agent does not actually remit them to the taxing authorities until the following year.[39]

If you borrow money to pay taxes the courts have held that you deduct the taxes in the year paid—not the year in which the loan is repaid.[40]

With respect to the possibility of purchasing the home of, or for, a dependent and thus obtaining a deduction for real estate taxes, see the discussion under "Interest" in Section 2.

Accrual-basis taxpayers have little opportunity for accelerating or accumulating deductions for taxes. They may deduct only such taxes as *accrue* and the amount and time of accrual are ordinarily either fixed or determinable with reasonable accuracy. Under the 1954 Code,[41] however, accrual basis taxpayers may for years beginning after 1953, instead of accruing and deducting the full amount of real estate taxes when the liability becomes fixed, accrue and deduct such taxes ratably over the *real property tax year* (but this election may not be selective as to particular properties—it is "all or none"). If you first acquire real property after 1953, you may elect on your return for the year of your first accrual to use this ratable deduction method. If you presently own real property however and have in the past used the usual accrual method, consent from the Treasury Department must be obtained to switch to the new method. Whether or not the new method is desirable depends on the relation between your income tax year, your real property tax year, and your accrual date under the usual method. You may find that you can double-up on a deduction; on the other hand, you could find a portion of the deduction completely lost during your lifetime. You should make careful calculations, check them, and then double-check them before applying for consent to change to the new accrual method.

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[36] On the assumption that you are on a calendar year basis.

[37] See footnote 36.

[38] But, in order to avoid controversy, pay in cash or by certified check.

[39] I.T. 1273, I-1 C.B. 125 (New York State income tax); also I.T. 3370 1940-1 C.B. 32 (City of Philadelphia income tax).

[40] *Ida Wolf Schick,* 22 B.T.A. 1067 (1931), vacated on other grounds; par. 31,156 Prentice-Hall Memorandum B.T.A.; also *William D. Hutchins,* 14 B.T.A. 421 (1928).

[41] 1954 IRC § 461(c).

5. How Casualty Losses Are Treated

Losses "of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck or other casualty, or from theft" [42] are allowable when sustained, to the extent not covered by insurance or otherwise. Since the inclusion in the tax laws of a provision for these losses,[43] a vast amount of litigation has resulted over the following questions:[44] (a) What is the amount of the loss? (b) What is meant by "other casualty"? (c) How can a loss by theft be proved? A discussion of these points follows:

a. How to determine amount of the loss. The courts have held, in a number of cases, that the amount of loss deductible is the difference between the market value immediately *before* the loss and such value immediately *thereafter*,[45] but that the deduction so determined must be limited to *cost* basis.[46] Thus, if your residence (exclusive of land) cost $15,000, was worth $30,000 on the day before it was completely destroyed by fire, and therefore then worth nothing, you would have suffered an economic loss of $30,000 because that is what it would cost you to replace the house, but your *deductible* loss is limited to $15,000, the cost.

Similarly, if you paid $1,000 for the land on which your home is located and another $1,000 in landscaping it, your land-cost is $2,000. But suppose, because of the natural development of the shrubbery and inflated market values, this land, as such, is now worth $10,000. An ice storm, followed by a wind storm, wreaks such havoc that on the day following, this land is reduced in value to $2,000. In spite of the fact that it may cost you another $10,000 to replace the trees and shrubbery, or that the value has been reduced by $8,000 in 24 hours, you have a taxable deduction of only $2,000, the cost basis. (Your basis in case of a sale is *zero*, because you have taken a deduction for the full cost.)

The greatest source of controversy in casualty losses is the determination of the values before and after the casualty. You will make estimates of the respective values and the appraisal section of the Internal Revenue Service will make others (ordinarily two or more years later) which may be lower than yours. None of the values thus stated can be the subject of an exact scientific determination. What, then, can be done to minimize the chances of an unfair settlement or unfavorable court decision in this connection?

If you have had a fire, storm loss, or other casualty,[47] you should:

1. Obtain the services of a reputable local appraiser who was familiar with the property before the loss was sustained and have him supply you with an affidavit stating his qualifications, his knowledge of the property and for how long a time

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[42] 1954 IRC § 165(c)(3); 1939 IRC § 23(e)(3).

[43] Originally in the Revenue Act of 1913 (§ II(b), fourth).

[44] In fact, it is seldom that controversies arise over any other questions.

[45] Principally *Helvering* v. *Owens*, 305 U.S. 468, 59 Sup. Ct. 260 (1939). But see W. F. *Harmon*, 13 T.C. 373, (1949) in which the cost of repairs was held to be a fair measure of the loss.

[46] Adjusted where necessary for additions, allowed losses, and depreciation allowed or allowable.

[47] Individuals seldom suffer shipwreck losses. If you do, however, the same general procedures should be followed. You would probably also immediately notify the Coast Guard.

he has known it, and his estimates of the values before and after the loss.

2. If the loss involves real property, have a number of photos or snapshots taken, showing the extent of the damage and if you have a map or blueprint, number the photos and indicate on such map or blueprint the location at which each was taken.[48]

3. Keep a careful record of the date of the loss or damage and preserve any newspaper clippings referring thereto.

4. Be sure you determine and record cost.

5. Send a registered letter to your local District Director of Internal Revenue, advising him of the loss and its location. Request that he send, immediately, a member of his appraisal section to view and make such notes as is deemed proper,[49] so that when your return is ultimately examined the agent will have some guide in determining the allowable loss. (Your request will probably go unheeded but should you find it necessary to take your case to court, you should be in an advantageous psychological position for having taken this step.)

If you have a loss by theft, even though the amount involved is small, be sure to report it immediately to the police, giving a detailed description of the property and its estimated value. You will have difficulty sustaining a deduction if you haven't shown sufficient interest in the property to attempt to recover it.

b. What does "other casualty" mean? A casualty has been defined by the courts as "an event due to some sudden, unexpected or unusual cause." [50] Webster's *New International Dictionary* defines a casualty as "an undesigned, sudden and unexpected event." The difference in these two definitions is significant; the court has used the conjunction "or," whereas Webster has used "and." In the light of the rulings and decisions below allowing and disallowing losses, it is obvious that Webster is still the supreme authority. The loss must be due to a "sudden, unexpected *and* unusual cause." Thus, losses resulting from the following have been allowed:

Automobile collision[51]
Automobile fire[52]
Drought damage to trees, plants, etc.[53]
Boiler explosion[54]
Fire destruction of residence and furniture[55]
Freezing of pipes; damage to residence and furniture[56]

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[48] This will eliminate the possibility that the Bureau can suspect that all the photos are of the same damaged area taken from different angles.

[49] But do not suggest that you want an agreement with the Appraisal Section as to the amount deductible on your return; it is not the policy of the Internal Revenue Service to make such agreements, and any suggestion that such policy be altered might be grounds for your request to be ignored.

[50] *Matheson et al.*, v. *Commissioner* (2 Cir. 1931), 54 F. 2d 537, 10 AFTR 945, and followed in numerous cases.

[51] Reg. 118 § 39.23(3)-1.

[52] *Tracy* v. *Buckwalter*, 20 B.T.A. 1005 (1930).

[53] *Buttram* v. *Jones*, 87 F. Supp. 322, 38 AFTR 1080 (D.C. Okla. 1949); also see Rev. Rul. 54-85, 1954 IRB No. 10 (p. 6).

[54] I.T. 2231, IV-2 C.B. 53.

[55] *Pope & Pope* v. *U.S.* (D.C. N.D. Calif. 1937) 22 AFTR 1224; *E. C. O'Rear*, 28 B.T.A. 698 (1933), affirmed (6 Cir. 1935) 80 F. 2d 473.

[56] O.C. 1076, 5 C.B. 138.

Storm damage to boat, boathouse and pier,[57] residence[58] and trees and shrubs[59]

These losses have been *disallowed:*

Accident; personal injury[60] and loss of finger ring[61]
Gratuitous bailee[62]
Corrosion of residence[63]
Excavation on adjoining land [64]
Loss in transit [65]
Termites and dry rot in residence[66]

If you suffer a casualty loss, therefore, not specifically named in the Internal Revenue Code, which includes only fires, storms, shipwreck and theft losses, it must be due to a cause falling within Webster's definition to be allowable.

c. How to prove loss by theft. If you claim a loss by theft you may be faced with proving two difficult facts:

1. You must prove that theft actually occurred. Webster's *New International Dictionary* defines theft as "the felonious taking and removing of personal property, with intent to deprive the rightful owner of it." Obviously, one rarely sees the thief "take and remove" one's personal property, but there must be fairly clear evidence that the loss resulted from theft and not from your own, or your agent's, misplacing or losing the property.[67] Where property was lost out of crates in transit the Court said, "It is true that theft constitutes a possible explanation for the absence of the items from the shipment, but there are other possible explanations which are as probable and possible as theft." [68]

Probably the surest way of proving theft is by advising the police immediately and then obtaining a copy of their report at the time. It might be difficult to get this report two or three years later when your return is being examined.

2. Once you have satisfied the examining agent that theft actually occurred, your next difficulty (and usually the more serious one) is to prove the amount of your loss. You will usually have a record of the cost of your home and your automobile, but the average person will not have a record of the cost of furs, clothing, paintings, radios, jewelry and the like. You are entitled to a deduction of the cost, or if you received property by gift, the cost to your benefactor. When you sustain a loss by theft, therefore, and can remember where you bought any of the articles, try im-

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[57] *Helvering* v. *Obici* (4 Cir. 1938), 97 F. 2d 431, 21 AFTR 527, affirmed 305 U.S. 468, 59 Sup. Ct. 260, 21 AFTR 1241.

[58] O.D. 698, 3 C.B. 159.

[59] G.C.M. 21,013, 1939-1 C.B. (Part 1) 101.

[60] O.D. 779, 4 C.B. 155.

[61] *Edgar F. Stevens,* par. 47,191 Prentice-Hall Memorandum T.C.; *Keenan* v. *Bowers,* (DCSC 1950), 91 F. Supp. 771, 39 AFTR 849.

[62] *Luther Ely Smith,* 3 T.C. 696 (1944).

[63] See footnote 50.

[64] *Daniel F. Ebbert,* 9 B.T.A. 1402 (1928).

[65] W. W. *Bercaw* v. *Commissioner,* par. 47,005 Prentice-Hall Memorandum T.C., affirmed (4 Cir. 1948) 165 F. 2d 521 (Casualty loss not discussed).

[66] U.S. v. *Rogers, et al.* (9 Cir. 1941), 120 F. 2d 244, 27 AFTR 423. But termite damage occurring within a relatively short period of time has been allowed. See *Rosenberg* (8 Cir. 1952), 198 F. 2d 46, 42 AFTR 303, remanding 16 T.C. 1360 (1951).

[67] O.D. 526, 2 C.B. 130. However, see W. *Roosevelt Thompson,* par. 42,093 Prentice-Hall Memorandum B.T.A. (1942).

[68] See footnote 65.

mediately to obtain duplicate bills (whether you charged the purchase or paid cash for it) or statements substantiating your purchases. Here again, your chances of proof diminish with the passage of time. Of course, if you are fully insured you get no deduction for theft losses, but if you have been unfortunate enough to let your policy lapse before theft occurs, the policy itself would furnish prima facie, though not necessarily conclusive, evidence of the *value* of the stolen items covered by the policy; *cost* would remain a major problem.

Other questions will arise (for example: the actual ownership of the property, the loss of which gives rise to the deduction taken; or the year in which the loss was sustained), but they are usually not too difficult of solution.

One further thought: Malicious mischief or vandalism does not fall into the definition of "theft" above, nor into any of the specific casualties that result in allowable losses and will not create a deduction. Thus, if an intruder enters your home and smashes your uninsured piano and paintings, you have no taxable loss but presumably if he carries them off your premises and across the street and creates the identical havoc, you *do* have such taxable loss.

6. How to Deduct for Medical and Dental Expenses

You may take as a deduction "expenses paid during the taxable year, not compensated for by insurance[69] or otherwise, for medical care[70] of yourself, your spouse or a dependent.[71]

The 1954 Code, however, made several changes in the medical expense deduction allowed by the 1939 Code. The following tabulation shows the principal differences:

	1939 Code	*1954 Code*
If neither you nor your spouse has reached the age of 65 before the end of the taxable year:		
(a) Medical expenses must be reduced by this percentage of adjusted gross income[72]	5 per cent	3 per cent
(b) The maximum deduction		
A. if you are married and file a joint return is	$2,500	$5,000
plus, for each dependent, not exceeding *two*	$1,250	$2,500
with a *total* maximum, thus, of	$5,000	$10,000
B. if you are the head of a household [73] or a surviving spouse[74] the deductions are	allowable under (C) below	allowable under (A) above
C. if you are single or if you are married and file a separate return, the maximum is	$1,250	$2,500
plus, for one or more dependents, no more than an additional	$1,250	$2,500
with a *total* maximum, thus, of	$2,500	$5,000

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[69] But disability benefit payments, as distinguished from hospitalization reimbursements, etc., are not "insurance" by which medical expenses must be reduced. *Robert O. Deming, Jr.*, 9 T.C. 383 (1947).

[70] Quotations from 1954 IRC § 213; 1939 IRC § 23(x).

[71] Only such dependents as defined in 1954 IRC § 152; 1939 IRC § 25(b)(3).

[72] 1954 IRC § 62; 1939 IRC § 22(n).

[73] 1954 IRC § 1(b)(2).

[74] 1954 IRC § 2(b).

	1939 Code	1954 Code
If either you or your spouse is 65 years of age at the end of the taxable year:		
(a) The medical expense deduction for *both* of you is allowable subject to the applicable maximum limitations described above.	In full	In full
(b) The deduction for medical expenses of a dependent, however, must be reduced by the following percentages of adjusted gross income	5 per cent	3 per cent

The 1954 Code contains two other important changes:

(a) *Medicines* and *drugs* must be separated from other medical and dental expenses, and their total expense must be reduced by 1 per cent of adjusted gross income before they can be included in the computation of the deduction for medical and dental expenses;[75] this is so whether you are *over* or *under* age 65. Thus, assume (1) that you or your spouse are over 65 at the end of the taxable year, (2) your adjusted gross income is $5,000, and (3) you have $150 of hospital and doctor expenses and $50 of drug and medicine expenses. Your medical expense deduction would be only $150, because your drugs and medicines expense of $50 would be entirely eliminated by 1 per cent of adjusted gross income (1 per cent of $5,000 = $50).

(b) Medical expenses of a decedent paid by his estate within one year after death may be treated as if paid by him at the time they were *incurred* (provided a waiver of the right to deduct or claim such expenses for estate tax purposes is filed).[76]

The term "medical care" is described as including "amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body (including amounts paid for accident or health insurance)." [77]

There follows a list of specific expenses which would fall into the above definition:

Ambulance hire
Artificial limbs
Chiropractors' and osteopaths' fees
Dentists' bills, dentures, etc.
Eyeglasses, examination fees, prescriptions, etc.
Fees of authorized Christian Science practitioners
Hospital bills
Insurance premiums on health, hospitalization or accident policies
Laboratory fees
Nurses, registered or practical, including board, where you are required to pay or furnish it
Physicians' and surgeons' fees
Psychologists' fees, where the psychologist is qualified and authorized under State law to practice
"Seeing-eye" dog and its maintenance

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[75] 1954 IRC § 213(b).
[76] 1954 IRC § 213(d).
[77] See footnote 70.

Special dietetic foods and vitamins, etc. where they are prescribed by your doctor (but be sure to retain the prescription or written instructions of the doctor)

Therapy treatments

Training costs in speech and lip reading

Traveling expenses for rendition of medical services or mitigation of illness (see paragraph next below)

X-rays

You will have little difficulty in substantiating, through receipted bills or cancelled checks, the payment of any of the above expenses constituting medical, dental, or like deductions, except, perhaps for traveling expenses. If your doctor advises you to go, or send a dependent, to a distant hospital or doctor for treatment or to a different climate for mitigation of an ailment, be sure to get his advice in writing and if such advice involves a change in climate, be sure that his reasons are stated. In this connection, however, you should remember that traveling expenses will not be allowed unless they are *primarily* for the cure, prevention or alleviation of a specific disease, illness or physical condition—a mere incidental benefit is not enough. This is emphasized in a court decision[78] which states the difference between sustaining and losing entirely the deduction under the 1939 Code:

> There can be no question that carefully chosen changes of climate are beneficial to most persons, or that vacations at appropriate resorts are desirable and conducive to better health. The record fails to show, however, that the benefit derived was in any respect different from that enjoyed by any vacationer at the same resorts at the same time.

The 1954 Code spells out the fact that only amounts paid for "*transportation primarily for and essential to* medical care" [79] are allowable. Board and lodging, except when actually in a hospital, are therefore completely ruled out by this provision (the point was not clear under the 1939 Code).

If it is necessary for a parent to accompany a minor child in traveling for treatment or mitigation of an illness, the traveling expenses of the parent are also deductible.[80] The traveling expenses and salary of a nurse accompanying an invalided patient would similarly be deductible.

A point to remember, where husband and wife have incomes of substantially equal amounts, is that it is the spouse who pays the medical expenses who is entitled to the deduction and must take it even though the expenses are paid for the other spouse or a dependent. If they file a joint return it does not matter, but they might save taxes if *one* of the spouses pays all the medical expenses and they then file separate returns. Where there are substantially "unbalanced" incomes, a joint return ordinarily results in a lesser tax and the question of who pays medical expenses is academic.

Inasmuch as medical expenses can only be deducted when paid, you might consider, as a means of postponing such expenses to another year, giving your doctor a note[81]—this would not constitute payment—and thus, in effect, getting two years' expenses into one year's tax return. In this way you might obtain a deduction which would otherwise be denied to you. If, for example, in a year to which the 1954 Code is applicable, you have adjusted gross income of $20,000 and medical expenses of $600 for two consecutive years, you will get no deduction. But if you can "double-up" on the expenses in one year, you would get a deduction in that year of $600.

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[78] *Edward A. Havey,* 12 T.C. 409 (1949).

[79] 1954 IRC § 213(e)(1)(B).

[80] I.T. 3786, 1946-1 C.B. 75. But see footnote 79.

[81] See footnote 18. Medical expenses must be paid and the issuance of a note is not payment.

A further point to remember is that if you have medical expenses in one year and are reimbursed through insurance in the next, you do not adjust the expenses in the earlier year. You *may* realize taxable income in the year of reimbursement. For example, assume that in a year after 1953 (a) you are single and have no dependents (b) your adjusted gross income is $10,000 (c) you paid medical expenses in 1954 of $3,300. Your deductible medical expense is $3,000 ($3,300 less 3 per cent of $10,000), but it is limited to $2,500. If you receive hospitalization or other sick benefit insurance in 1955 of $250, you report no taxable income in that year. If you receive $1,000, you report $500, the difference between the amount not deductible because of the limitation and the amount reimbursed.

Assume the same facts as above except that you paid $4,000 of medical expenses in 1954 and were reimbursed the total expense of $4,000 in 1955. Your deduction was limited to $2,500 in 1954 and that is all you are required to include in taxable income in 1955.[82]

7. How to Treat Non-Trade and Non-Business Expenses

Expenses in connection with the "production or collection of income or for the management, conservation or maintenance of property held for the production of income" are deductible as non-trade or non-business expenses; the 1954 Code added also expenses "in connection with the determination, collection or refund of any tax." These expenses, however, are allowable only provided they are "ordinary and necessary." [83] The term "ordinary and necessary" means that the expenses must bear a proximate relationship to the income or income-producing properties and they must be reasonable in amount. But they need not necessarily be constant or recurring.[84]

Among the expenses falling within this classification would be the following:

Accountants' fees for preparing annual accounts and tax returns or for bookkeeping services.

Attorneys' fees for litigation over tax matters, protecting income-producing property against claims (but not for perfecting or protecting title) or in connection with investments.

Caretaker of real property rented or held for sale.[85]

Custodian fees.

Clerical salaries.

Investment counsel fees.

Management fees.

Maintenance of real property, including a former residence which has been abandoned as a home and is for sale or being held for market rise.

Office rent and expense.

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[82] Reg. 118, § 39.23(x)-1.

[83] Quotations from 1954 IRC § 212; 1939 IRC § 23(a)(2).

[84] *Welch* v. *Helvering*, 290 U.S. 111, 54 Sup. Ct. 8, 12 AFTR 1456 (1933).

[85] But see *Warren Leslie, Sr.*, 6 T.C. 488 (1946).

Safe deposit box rental.
Traveling in connection with income-producing properties.

It is not necessary that you derive income from property in the year in which the expenses are paid or incurred; such expenses are deductible even though they relate to past or prospective income or to property producing no income but being held with the expectation of realizing gains or minimizing losses.[86]

There are few ways of increasing your deductions of non-trade or non-business expenses except by maintaining careful records of all such expenses so that none are lost to you. *Cash-basis* taxpayers may anticipate or defer certain expenses and thus obtain the deduction in the year most beneficial taxwise; *accrual-basis* taxpayers must deduct all such expenses when they are incurred.

If your income consists of both taxable and nontaxable income, non-trade and non-business expenses must be apportioned[87] and such proportion as is allocable to nontaxable income is not allowable. However, if you have capital gains, in making the allocation add to your taxable income the gross amount of your capital gains without diminution for capital losses and without reduction of long-term gains to the taxable gains. For example, if you have $10,000 of dividends, $5,000 of tax-exempt interest and a capital loss of $4,000 (of which only $1,000 is allowable), such loss consisting of $50,000 of gross gains and $54,000 of gross losses, your allocation factors would be $60,000 taxable income ($10,000 of dividends plus $50,000 gross capital gains) and $5,000 nontaxable income (the tax-exempt interest).[88]

8. The Deduction for Dependent Care Expenses

The 1954 Code contains a completely new—and much-needed—provision[89] affording a measure of tax relief for qualified taxpayers who, in order to attend their places of employment, must incur expenses in providing for the care of certain specified dependents. There are four points in connection with this deduction, which will be discussed below.

Who is entitled to the deduction? Because of limitations and qualification, taxpayers who may get the dependent care deduction fall into four classes:

Unmarried women (and a woman legally separated from her husband at the end of the taxable year under a decree of divorce or of separate maintenance is not considered married);
Married women, whose husbands also work;
Married women, whose husbands are mentally or physically incapable of self-support;
Widowers (and an unmarried taxpayer who is legally separated from his wife under a decree of divorce or of separate maintenance is considered as a widower).

It may seem harsh to deny any deduction to a husband who must pay for the care of children because, say, his wife is hospitalized, or in a mental institution, but non-widowers are excluded from this special provision.

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[86] Reg. 118 § 39.23(a)(15).

[87] 1954 IRC § 265; 1939 IRC § 24(a)(5). But if expenses are allocable, taxpayer has the burden of proof of the allocation, lacking which all such expenses may be disallowed. See *Claire S. Strauss*, par. 43,217 Prentice-Hall Memorandum T.C.

[88] There is no authority which can be cited for this treatment, but as a matter of policy, the Internal Revenue Service has permitted it for the past several years.

[89] 1954 IRC § 214.

Even though you fall within one of the four classes listed above, the deduction will be allowed *only* if the care is for the purpose of enabling you to be *gainfully employed.*[90] If, for example, you incur expenses for the care of your children so that you may contribute gratis service to some worthwhile church or charitable enterprise, you get no deduction, because this laudable endeavor of yours is not *gainful.* On the other hand, you do not have to receive a *salary* or *wages* to qualify. You can operate your own shop, or restaurant, or other sole proprietorship, or you can be a partner in a business venture. In either case you would be gainfully (self-) employed.

What dependents qualify? In order for you to be entitled to the deduction, your dependent must have less than $600 of gross income for the taxable year for which the deduction is taken, and must meet the usual dependent's citizenship or residence requirements.[91] Qualifying dependents are further limited to those, (a) who are sons, stepsons, daughters or stepdaughters, (including any of those legally adopted), and who have not attained the age of 12 years, or (b) who are mentally or physically incapable of caring for themselves (irrespective of age).

As will be seen in the section of this subject immediately following, a change in the status of a dependent during the year is not fatal to the deduction.

What expenses are includible? Generally speaking, any expenses paid for the care of a qualified dependent during the hours of your employment are includible. There are two exceptions:

a. Payments to a person who is also a dependent of yours are not allowed. For example, suppose you are a widower and you pay your sister, whom you claim as a dependent on your return, to care for your 10 year old child. The amounts you pay her cannot be included in dependent care expenses.

b. Payments for medical care of a qualified dependent cannot be included if they are deducted as medical expenses (as to which see Section 6 above). Thus, if you have a dependent who is physically incapable of caring for himself, and you employ a nurse to attend him while you are at work, you cannot include this expense as a medical deduction, and also as dependent's care expenses—nor would it appear that you may divide one expense solely because it would otherwise be subject to deductible limitations.[92] There is no question however that you may treat, say, nursery school tuition as dependent care expense, and nurses' or doctors' fees for services to the dependent as medical expenses, if you choose.

If you incur an expense which is partly for the care of a dependent, and partly for a non-deductible personal expense, this expense must be allocated to the different types of services. If, therefore, you pay tuition to a nursery school for full days of care of your children under 12, but you work only half of each day, only one-half of the tuition would be includible. Similarly, if you employ a maid on a full-day basis while you are at work for the whole of each day, and her duties consist of housework *and* care of children under 12, an allocation of the expense of the maid would be required—perhaps one-half to each duty. A further allocation would be required if you worked only a part of the year during which you had a full-time maid. No amount would be includible for this expense for the time you were *not* working;[93] it would be allocable *after* you started working. But if you have two children, one *under* 12 years of age and the other *over* 12 years old, no allocation of the total expenses of caring for both is apparently required.[94]

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[90] Apparently "enabling" a taxpayer to be gainfully employed includes active *search* for employment. (So states Senate Report No. 1622, p. 221—June 18, 1954).

[91] 1954 IRC § 152(b)(3).

[92] 1954 IRC § 213(f) states that "any *expense* allowed as a deduction" for dependent's care is not allowable as a medical expense deduction. It would seem therefore that nursing service "expense" must be entirely treated as one or the other. This point is not entirely clear however and it may be possible to treat *nursing services* as dependent's care and, say, *doctor's fees* for the same dependent as medical expenses.

An allocation may also be required where a dependent ceases to be, or becomes, a qualified dependent at any time during your taxable year. If a child attains the age of 12 during the year, only those expenses for its care prior to its 12th birthday are includible. Or if a dependent becomes ill and unable to care for himself within your taxable year, expenses for his care during the period of his illness are includible; this period may both begin and end in the same year.

To what extent is the deduction limited? Firstly, the maximum amount of dependent care expenses you can deduct is $600,[95] regardless of the *number* of dependents you provide care for. For example, if you have three dependents for whom you must provide care, and your expenses are $500 *each*, or a total of $1,500, you may nevertheless deduct only $600.

There is a further possible limitation on working wives whose husbands also work. They *must* file a joint return, and if their combined adjusted gross income exceeds $4,500, the deduction cannot exceed $600, *reduced* by the excess of adjusted gross income *over* $4,500.[96] Thus, if your dependent care expenses are $1,000 and your and your wife's adjusted gross income is $5,000, your deduction is *not* $500, but, $100 (*maximum* of *$600* reduced by the excess of actual adjusted gross income over $4,500).

The amount of income of an unmarried woman, a married woman whose husband is mentally or physically incapable of caring for himself, or a widower, has no bearing on their deduction. Their adjusted gross income may be $10,000, or $20,000, and they would still be entitled to the first dollar of dependent care expenses; they are limited only to the over-all maximum.

NOTE: Exemptions for dependents, otherwise allowable, or for spouses, are *not* affected by this special deduction for the expenses of their care.

9. Conclusion

The most important factor in getting greatest individual deductions is the careful and accurate recording of each and every transaction into which you enter, whether it be the payment of a $5 doctor's fee or of a real estate tax bill of hundreds or thousands of dollars. Such recording may be in the form of a checkbook, supplemented by a note-pad, or an elaborate double-entry set of formal books. But record them you must! Court histories are replete with decisions against taxpayers because of lack of substantiation of income and deductions through adequate records. Countless thousands of individual taxpayers have overpaid untold millions of dollars in taxes because of their failure to keep records; their returns are either improperly prepared when filed or an additional tax results when it is examined because the taxpayers cannot prove what they know to be facts.

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[93] Senate Report No. 1622, p. 221—June 18, 1954.

[94] See footnote 93, above.

[95] 1954 IRC § 214(b)(1)(A).

[96] 1954 IRC § 214(b)(2).

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Medical Expenses

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Deductibility of medical expenses is relatively new and the rules are still changing. Considerable changes were made by the 1954 Internal Revenue Code. This chapter will tell what medical expenses may be deducted, what must be excluded, how to make medical payments to get the greatest benefit, and how to compute the deduction.

1. Points to Consider

Section
What is included as medical expense? 2
What is not included as medical expense? 2
What about payments for medical insurance? 2
What about proceeds of medical insurance? . . . . . . 3(a), (e)
How is the deduction limited? . . . . 3(b), (c), (d)
What expenses paid for others may you deduct? . . . 4
Should husband or wife pay medical bills? 5
In which year should medical bills be paid? 5

2. What is Included as Medical Expense?

The Code defines medical expenses as "amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body."[1] Also allowable is "transportation primarily for and essential to "such medical care.[2] This means that you may deduct payments to doctors, dentists, nurses, Christian Science practitioners,[3] chiropractors,[4] osteopaths[4] and psychologists[5] as well as amounts paid for hospital care, ambulance hire, drugs, nursing, eyeglasses, dentures, etc.

You may deduct the premium for medical insurance if it is for the purpose of meeting hospital or doctors' bills.[6] This includes Blue Cross and Blue Shield and similar payments[7] and any specified premium for your medical expenses in your automobile insurance. If the insurance is merely compensation for time lost during sickness, it is not considered to be medical expense.[8]

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[1] 1954 IRC § 213(e)(1)(A); 1939 IRC § 23(x).
[2] 1954 IRC § 213(e)(1)(B). Not specifically allowed by 1939 Code.
[3] Bureau letter 2/2/43, 433 CCH 6175.
[4] I.T. 3598, 1943 C.B. 157.
[5] Rev. Rul. 143, 1953-2 C.B. 129.
[6] 1954 IRC § 213(e)(1)(A); 1939 IRC § 23(x).
[7] Reg. 118, § 39.23(x)-1(d)(1).

Travel for specific treatment or prevention is allowable under the wording quoted above, but mere journeying to a more beneficial climate with no specific requirement for such change is classed as a non-deductible personal expense even, sometimes, where a physician has advised it.[9] If the climate is an essential part of the treatment, travel to reach it is allowable.[10] Where the travel of a young child qualifies as medical expense and a parent must go with the child, the parent may also deduct his own reasonable travel expenses.[11]

In one case,[12] an aged invalid, not helpless, was allowed to deduct part of the cost of an attendant who was not a registered nurse. In another case,[13] the cost of a practical nurse for a normal infant whose mother had died in childbirth was held non-deductible. One District Judge has held [14] that taxi fares were deductible where (1) the taxpayer was "totally disabled," (2) her doctor had prescribed employment as a form of occupational therapy, and (3) the taxi was essential to take her to and from work.

The Commissioner and the courts have held that you may not deduct the cost of capital additions, such as a swimming pool, an elevator, or an inclinator.[15]

3. Computation of Medical Expenses—Four Exclusions

a. Amounts compensated for by insurance or otherwise. If you are compensated for medical expense by insurance or otherwise, you must reduce your expense by the insurance proceeds in computing the deduction.[16] If you pay the expense in one year and collect the insurance in the next, the full deduction is allowed, but you must include the insurance (limited as explained in (e) below) as income in the subsequent year.

b. One per cent of gross income as to medicines and drugs. In computing the deductible amount for medicines and drugs, 1 per cent of your adjusted gross income[17] must first be eliminated.[18] Where income spreading[19] is used, adjusted gross income is computed after reallocating the income.[20] For the purpose of the 1 per cent limit, adjusted gross income does include net capital gains.[21]

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[8] I.T. 3967, 1949-2 C.B. 33; I.T. 3970, 1949-2 C.B. 28. Also compare *Robert O. Deming, Jr.* 9 T.C. 383 (acq. 1948-1 C.B. 1); Rev. Rul. 19, 1953-1 C.B. 59.

[9] *Edward A. Havey*, 12 T.C. 409 (1949); *Herman A. Brody*, par. 49,071 Prentice-Hall Memorandum T.C. (1949); *Martin W. Keller*, par. 49,185 Prentice-Hall Memorandum T.C. (1949); *Samuel Dobkin*, 15 T.C. 886 (1950); *Frances Hoffman*, 17 T.C. 1380 (1952).

[10] *Commissioner* v. *Stringham* (6 Cir. 1950), 183 F. 2d 579, 39 AFTR 777; *William H. Duff II*, par. 53, 362 Prentice-Hall Memorandum T.C. (1953); *William B. Watkins*, par. 54, 102 Prentice-Hall Memorandum T.C. (1954); *Edna G. Hollander*, 22 T.C. No. 84 (1954).

[11] I.T. 3786, 1946-1 C.B. 75.

[12] *Estate of Jacob Hentz, Jr.*, par. 53,110 Prentice-Hall Memorandum T.C. (1953).

[13] *George B. Wendell*, 12 T.C. 161 (1949).

[14] *Misfeldt* v. *Kelm*, 1952 Prentice-Hall 72,655 (1952).

[15] Rev. Rul. 54-57, 1954-7 I.R.B. 9; *Edna G. Hollander* 22 T.C. No. 84 (1954).

[16] 1954 IRC § 213(a); 1939 IRC § 23(x); Reg. 118, § 39.23(x)-1(d).

[17] Defined in 1954 IRC § 62; 1939 IRC § 22(m).

[18] 1954 IRC § 213(b); new in 1954 Code.

[19] 1954 IRC § 1301 to § 1304; 1939 IRC § 107.

[20] *Edward C. Thayer* 12 T.C. 795 (1949); I.R. Mim. 43, 1952-2 C.B. 112.

[21] Bureau Letter 1/4/44, 1944 Prentice-Hall Fed. 66,135.

c. Three per cent of adjusted gross income. You may deduct only the excess of your medical expenses over 3 per cent of your adjusted gross income (see b., above).

The 3 per cent exclusion does not apply where the taxpayer (either taxpayer if a joint return is filed) is over 65,[22] but if you pay expenses for a dependent over 65, the exclusion must still be applied. It must also be applied to payments for a dependent by a taxpayer who is over 65.[23]

d. Amounts in excess of the maximum. The maximum deduction can be found from the following table:[24]

	DEPENDENTS			
	None	One	Two	Three or more
Married couple filing jointly	$5,000	$7,500	$10,000	$10,000
Surviving spouse* or head of household	2,500	5,000	7,500	10,000
Other taxpayers	2,500	5,000	5,000	5,000

* As defined in 1954 IRC § 2.

e. Insurance proceeds in subsequent year. Any insurance received for expenses deducted in a prior year must be reported as income.[25] If some of the prior year's expense was disallowed because of the top limit, that part of the insurance can be disregarded. Also, the inclusion for insurance for the current year should not exceed the expense deduction for the prior year, after excluding 3 per cent of net income. In other words, you can compute the deduction actually taken and then compute the amount that you would have been allowed if the insurance had been received in the same year as the expense. The difference is what you must report as income.

4. Whose Expenses May be Deducted?

You may deduct only expenses you yourself have paid; however, they may be your own expenses, those of your spouse, or those of a dependent.[26] For this purpose, a dependent must be over 50 per cent supported and must be one of the relatives specified in Code section 152.[27] The rule that a dependent must have income of less than $600 does not apply here, however, nor is the dependent precluded from making a joint return with a spouse.[28] It should be noted that if either of the last two conditions applies, the dependent is not considered in computing the maximum allowance.[29] (See d., above.) Thus, a father filing a joint return with his wife may, if he provides more than half her support, deduct medical expenses paid for his daughter who files a joint return with her husband, but the maximum deduction for the parents is $5,000.

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[22] 1954 IRC § 213(a)(2)(A); 1939 IRC § 23(x)(2).

[23] 1954 IRC § 213(a)(2)(B); 1939 IRC § 23(x)(2)(B).

[24] 1954 IRC § 213(c); the maximums under 1939 IRC § 23(x) were lower.

[25] Reg. 118, § 39.23(x)-1(e).

[26] 1954 IRC § 213(a); 1939 IRC § 23(x).

[27] Corresponds to 1939 IRC § 25(b)(3).

[28] Because these limits appear in 1954 IRC § 151(e) (1939 IRC § 25(b)(1)(D)) whereas 1954 IRC § 213(a) (1939 IRC § 23(x)) refers only to 1954 IRC § 152 (1939 IRC § 25(b)(3)); I.T. 4034, 1950-2 C.B. 28.

[29] I.T. 3703, 1945 C.B. 127.

Medical expenses of a decedent which are paid within one year after his death are deductible on his return as though they had been paid on the date incurred.[30] Any amounts not so deducted may be deducted from the gross estate, since they comprise valid debts of the estate.[31] The latter treatment does not require the 1 per cent and 3 per cent exclusions, nor does any maximum apply.

5. How Should Payment Be Made?

Where a joint return is to be filed, either spouse may pay the medical bills; it makes no difference in the tax. If separate returns are being filed it might be advisable for the spouse having the smaller amount of income and hence the smaller exclusion on the 1 per cent and 3 per cent rules to pay the medical bills. However, you may benefit from taking a smaller deduction at a higher tax rate rather than a greater deduction at a lower rate. In a community property state it should be noted that medical expenses paid from community funds must be split between the two spouses[32] so that the above method would apply only if separate funds are used.

You may deduct medical expenses only in the taxable year in which paid.[33] If a payment would be non-deductible because you have already reached your maximum, defer it until the next year if possible. If, near the end of a year, you have not spent 3 per cent of your adjusted gross income, you may be wise to defer the payment on the chance of using it in the next year. You may also be able to take the standard deduction in one year and itemize in the next; if so, you would steer as many as possible of your medical payments to the year of itemization.

When a decedent owes medical bills, a larger deduction may be obtainable if the survivor pays them. You should also consider whether deducting the entire amount against the gross estate might be better than deducting only the excess over the exclusions (further limited by the allowable maximum) from your income tax.

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[30] 1954 IRC § 213(c); this was not true under the 1939 Code, see: *Estate of Edwin F. Borden,* par. 50,185 Prentice-Hall Memorandum T.C. (1950). *Estate of I. C. Triplett, Sr.,* par. 50,198 Prentice-Hall Memorandum T.C. (1950).

[31] Reg. 105, § 81.36.

[32] Rev. Rul. 55-479; 1955-1 I.R.B. 9.

[33] 1954 IRC § 213(a); 1939 IRC § 23(x); Reg. 118, § 39.23(x)-1(a).

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How to Cut Individuals' Income from Interest

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Interest is one of the principal and most familiar components of taxable income. Planning individuals' investments, therefore, in order to cut income from interest to the extent consistent with other considerations such as investments yield, assumes prime importance.

1. Points to Consider

A sound plan for cutting one's income from interest should take account of the following points considered in this chapter:

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2. Taxable Interest

a. The nature of taxable interest. The Federal Revenue Acts since 1913, as well as the Internal Revenue code,[1] have specifically included interest in taxable income.[2] Although the concept of interest is very broad in scope, it is fairly well-defined. Interest is an amount allowed by applicable law or fixed by agreement between the debtor and creditor "for use, or forbearance, or detention of money."[3] It must be fixed by a binding legal obligation. A purely voluntary payment of interest by a debtor when there is no agreement and consequently no legal obligation to pay is a gift, not interest.[4] But the meaning of the word "interest," as used in the code is not restricted to payments which one has contracted to make for the use of borrowed money. Interest may be not only the price paid for the use of borrowed money, but also that paid a creditor for his forbearing to demand the payment of money legally due. Thus, in those states that still recognize the validity of a gratuity under seal, payments made pursuant to the instrument are interest payments.[5] In most jurisdictions, however, gratuitous notes, even under seal, are not enforceable and such notes do not meet the test of "indebtedness" under Section 163(a) of the 1954 Internal Revenue Code.[6]

b. Interest distinguished from penalties. The authorities indicate that, to constitute interest, the amount in question must be measured by elapsed time, thus distinguishing it from items such as penalties, which are fixed without reference to time.[7]

c. Interest in installment payments. Sometimes a partial payment is made on an interest debt. The parties have a right to allocate the payment between interest and principal as they see fit. Such allocation is binding for federal tax purposes.[8] In those cases where the agreement does not provide for an allocation between principal and interest, the entire payment is applied first to the interest due on the obligation and then to principal, at least when the state law so provides.[9] This rule does not apply, however, in a lump sum settlement of the entire debt for less than its face amount. In such cases an allocation between principal and interest on a proportionate basis is recommended.[10]

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[1] 1954 IRC § 61; 1939 IRC § 22(a).

[2] It would seem that interest would have been considered taxable income, apart from specific reference thereto in the income tax statutes, by virtue of the broad definition of gross income which includes "gains, profits, and income." 1954 IRC § 61; 1939 IRC § 22(a).

[3] *Fall River Electric Light Company*, 23 B.T.A. 168, 171 (1931).

[4] *Jessie Chase*, 19 B.T.A. 1040 (1930) acq.

[5] *Park* v. *Commissioner* (3 Cir. 1940), 113 F. 2d 352, 25 AFTR 367.

[6] *Woodward* v. *U.S.* (D.C. Iowa 1952), 106 F. Supp. 22, Par. 72,519 P-H Fed. 1952.

[7] *Intercounty Operating Corporation*, 4 T.C. 55 (1944); *District Bond Company*, 1 T.C. 837, 840 (1943).

[8] *Huntingdon-Redonda Co.* v. *Commissioner*, 36 B.T.A. 116 (1937) G.C.M. 2861, VII-1 C.B. 255, 1928.

[9] *Theodore R. Plunkett*, 41 B.T.A. 700, 709 (1940), (1 Cir. 1941) 118 F. 2d 644, 26 AFTR 880. Sec. 163 (1954 IRC) as passed by the House would have permitted a deduction for carrying charges in installment purchases, even though the charges were not stated separately. The Senate, however, deleted this provision.

d. Interest distinguished from capital recoveries. Recoveries of capital should be distinguished from interest receipts. The purchase of bonds with defaulted interest coupons attached represents a capital investment. The subsequent collection of the defaulted coupons is not a collection of "interest" but represents a return of capital.[11] But the sale of an obligation having accrued interest due thereon results in interest income to the extent the selling price received exceeds the basis of the obligation.[12] Likewise the portion of a condemnation award denominated interest constitutes ordinary income and is not part of the award, which represents a return of capital.[13] Interest on a judgment is also taxable notwithstanding the fact that the principal of the judgment may not be income.[14]

e. Interest distinguished from dividends. It is sometimes difficult to determine whether a given receipt constitutes interest or a dividend. The distinction was of little consequence to the individual taxpayer prior to the establishment, by the 1954 Act, of a dividend exclusion and credit for individuals. The distinction has always been vital to the corporate taxpayer because of the dividends received credit and the fact that the corporate payor is entitled to a deduction for interest but not for dividends.

The difficulty most often arises in those cases where corporate securities are so worded as to leave doubt whether they are stocks or bonds. About all that can be said is that the security in question must be examined with respect to its every significant aspect. No single characteristic is conclusive. A number of factors must be taken into consideration in determining whether a certain security is stock or evidence of indebtedness.[15] The following are some of the factors usually considered significant: the name given to the security,[16] the label placed on the payment made,[17] (i.e. whether the payment is designated dividend or interest), the intention which motivated issuance,[18] whether the security has a fixed maturity,[19] remedies available to the holder to enforce payment,[20] whether the payment of interest is or is not contingent upon earnings,[21] the absence or presence of voting rights,[22] the validity of the debt,[23] priority provisions for payment,[24] and finally the overall picture of the debt structure of the corporation.[25] In recent years, the last factor mentioned, the overall debt structure, has assumed a position of prime importance in the decided cases. This factor is fully discussed elsewhere in this book.[26]

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[10] *Warner Company*, 11 T.C. 419 (1948), (3 Cir. 1950) 181 F. 2d 599, 39 AFTR 414.

[11] *Erskine Hewitt*, 30 B.T.A. 962 (1934); *William C. Carman*, 13 T.C. 1029 (1949); *Morris Shanis*, 19 T.C. No. 80 (1953).

[12] *Charles T. Fisher*, 19 T.C. No. 52 (1952).

[13] It has been so held even though the award is from a state or local subdivision thereof, the obligations of which would ordinarily be tax-exempt. See: *United States Trust Company* v. *Anderson* (2 Cir. 1933), 65 F. 2d 575, 12 AFTR 836, cert. den. 290 U.S. 683; *Kiselbach, et al.* v. *Commissioner*, 317 U.S. 399 (1943), 30 AFTR 370.

[14] *Henri Chouteau*, 22 B.T.A. 850 (1931), *Commissioner* v. *Raphael* (9 Cir. 1943), 133 F. 2d 442, cert. den. 320 U.S. 735, 30 AFTR 294.

[15] *John Kelly Co.*, 1 T.C. 457, 462, affirmed 326 U.S. 521 (1946), 34 AFTR 314; *New England Lime Co.*, 13 T.C. 799, 803 (1949) (acq.).

[16] *First Mortgage Corporation of Philadelphia* v. *Commissioner* (3 Cir. 1943), 135 F. 2d 121, 30 AFTR 1389.

[17] *Ibid.*

[18] *Commissioner* v. *Meridian and Thirteenth Realty Co.* (7 Cir. 1942), 132 F. 2d 182, 30 AFTR 559.

[19] *Mullin Building Corporation* v. *Commissioner*, 9 T.C. 350 (1947), affirmed (3 Cir. 1948), 167 F. 2d 1001, 36 AFTR 1005.

[20] *Green Bay & Western Railroad Co., et al.* 3 T.C. 372 (1944), affirmed (7 Cir. 1945), 147 F. 2d 585, 33 AFTR 715.

f. Interest received in the form of marketable property. It is well to note that interest may be paid in marketable property as well as cash. Thus, if notes are received in payment of interest, and if the notes are marketable, or collateral is deposited, income may be realized.[27] Similarly, the value of scrip issued in payment of bond interest is held to be income to a cash basis taxpayer.[28]

3. When is Interest Taxable?

Planning for the minimization of taxes on interest must, of course, take account of the year in which interest is reportable as taxable income. A great deal of tax saving can be achieved by arranging, wherever possible, to have interest taxed in low income years.

a. Cash basis taxpayer. The general rule is that a cash basis taxpayer reports interest in the year payment is received, unless the interest is constructively received in an earlier year. Interest is constructively received if it is credited or set apart for the taxpayer without any substantial limitation as to the time or manner in which he can receive it.[29] For example—Interest coupons that have matured constitute taxable income in the year of maturity, even though they are not actually cashed, unless it can be shown that there are no funds available for payment.[30] Similarly interest on bank deposits constitutes income to a cash basis taxpayer, even though the bank nominally has a rule, which is rarely enforced, requiring notice before withdrawals are permitted.[31] Interest credited on shares of building and loan associations is taxable in the year of credit, if there is no restriction on the right of withdrawal. A restriction on withdrawal exists, where the rules of the association provide that the amount credited as interest is reduced if the shares are cashed before maturity. In such cases the interest credited annually is not reportable until the maturity of the shares.[32]

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[21] *Helvering* v. *Richmond, Fredericksburg & Potomac Railroad Co.* (4 Cir. 1937), 90 F. 2d 971, 19 AFTR 984.

[22] *Hemingway-Johnson Furniture Co., Inc.*, Par. 48,113 Prentice-Hall Memorandum B.T.A. (1948), affirmed (5 Cir. 1949) 174 F. 2d 793, 37 AFTR 1515.

[23] *Graves Brothers Co.*, 17 T.C. 1499 (1952).

[24] *Commissioner* v. *H. P. Hood & Sons, Inc.* (5 Cir. 1944), 141 F. 2d 467, 32 AFTR 423.

[25] *Ruspyn Corporation*, 18 T.C. 769 (1952) (acq.).

[26] See the chapter entitled "How to Capitalize and Recapitalize a Business" (section dealing with thin incorporations).

[27] *Great Southern Life Insurance Co.*, 36 B.T.A. 828 (1937). If in the case of default in interest on notes, the creditor accepts new notes for the face amount of the old notes plus accrued interest the new notes will not constitute receipt of interest income unless additional security is put up; or the new notes for some other reason are shown to have definite market value.

[28] *Charlotte L. Andrews*, 46 B.T.A. 607 (1942), (2 Cir. 1943), 135 F. 2d 314, 30 AFTR 1437 cert. den. 320 U.S. 748.

[29] Reg. 118, § 39.42-2.

[30] Reg. 118, § 39.42-3.

[31] Reg. 118, footnotes 29 and 30 above.

In accordance with the general rule a cash basis taxpayer who deducts interest in advance upon making a loan realizes no income until he receives repayment or until he disposes of the obligation by rediscounting.[33] An exception to the general rule that a cash basis taxpayer must report interest in the year payment is actually or constructively received is provided for in the case of United States savings bonds and other similar obligations issued at a discount. For taxable years subsequent to December 31, 1940, a cash basis taxpayer may elect to report as income the annual increment in the value of such an obligation as it accrues.[34]

b. Accrual basis taxpayer. An accrual basis taxpayer is required to report interest income at the time the debtor's obligation to pay interest matures. Reporting such interest is not required, however, if the facts available at the end of the taxable year indicate that collection of the interest is unlikely, as in cases where the debtor is known to be insolvent.[35] If the interest is subsequently collected, the accrual-basis taxpayer should report the interest, not necessarily in the year when received, but when available information indicates that the debtor became solvent.[36] Special rules apply when bonds are sold between interest dates. If bonds are sold between interest dates at a specified price plus accrued interest that portion of the selling price representing accrued interest is taxable to the seller in the year of sale as interest income.[37] The purchaser of such bonds, however, may not deduct the accrued interest paid to the seller. The interest so paid is deducted from the first collections of interest income received from the obligor.[38]

4. Examples of Taxable Interest

The following are some of the principal examples of taxable interest:

a. Interest on simple loans whether evidenced by note, or on open account.

b. Interest on bank deposits.[39]

c. Usurious interest constitutes taxable income to an accrual basis taxpayer, even though it is legally uncollectible, if the information available at the close of the taxable year indicates that the interest will probably be collected.[40] On the cash basis, usurious interest is reportable income in the year of its receipt, even though its collection is illegal and its payment may be recovered by the borrower.[41]

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[32] G.C.M. 17025, 1936-2 C.B. 155.

[33] G.C.M. 14839, XIV-1 C.B. 73; *Commissioner* v. *Central Republic Trust Co.* (7 Cir. 1935) 75 F. 2d 708, 15 AFTR 295. An accrual basis taxpayer reports the discount pro rata as earned over the life of the note. *Chatham & Phenix National Bank,* 1 B.T.A. 460 (1925), S.M. 3820, IV-2 C.B. 32.

[34] 1954 IRC § 454; 1939 IRC § 42(b). Election to accrue is binding for all future tax years, with the one exception that it does not bind a transferee. Once an election is made, permission to change methods must be obtained from the Commissioner.

[35] *The Corn Exchange Bank* v. *U.S.* (2 Cir. 1930), 37 F. 2d 34, 10 AFTR 276. *Atlantic Coast Line R.R. Co.,* 31 B.T.A. 730 (1934) (acq.).

[36] *Clifton Manufacturing Co.* v. *Commissioner* (4 Cir. 1943), 137 F. 2d 290, 15 AFTR 1187.

[37] I.T. 3175, 1938-1 C.B. 200.

[38] *Great Southern Life Insurance Co., Ibid.*

[39] Interest on a note issued to a single payee but deposited to a joint bank account is, nevertheless, interest income to the payee of the note only. *F. M. Robinson,* 4 B.T.A. 47 (1926) (acq.). Where taxpayers are joint holders of a note they are to be considered joint-tenants and each one must report one-half the interest paid as income. *Frederick J. Haynes,* 7 B.T.A. 465 (1927) (acq.).

d. Interest on corporation bonds is, of course, generally reportable as taxable income.[42] It is immaterial that the corporation itself may be exempt from income tax.[43] Thus, interest-bearing bonds issued by various tax-exempt organizations are fully subject to tax in the hands of individual holders. In case of so-called tax-free covenant bonds issued prior to January 1, 1934, the issuing corporation, in the case of interest payments to a United States citizen or resident, pays a portion of the tax equal to 2 per cent of the interest. The holder of the bonds reports the full amount of interest but takes a credit for the amount of tax paid by the issuer.[44] The credit for tax-free covenant bond interest is not available if the taxpayer chooses the optional standard deduction.[45]

e. Interest on obligations secured by mortgages is includible in gross income. A special problem arises if the mortgagee forecloses on his mortgage by bidding the face amount of the mortgage, plus accrued but unreported interest. The accrued interest has been held by the Supreme Court[46] to be taxable interest income, even though the value of the property received is less than the face amount of the mortgage. This rule has since been disapproved by the lower courts,[47] and the ultimate determination of this question must await future decision. Until the question is finally settled the mortgagee should, where circumstances permit, bid the property in for no more than the principal amount of the debt. It does seem clear, however, that if a mortgagee accepts a deed in lieu of foreclosure in cancellation of principal and interest, taxable interest income will be deemed realized only to the extent that the value of the property received exceeds the principal of the loan.[48]

f. Interest on United States obligations is subject to tax, unless specifically exempt by law. In any event, interest on payments by the Federal and State governments or political subdivisions of a State is subject to tax unless it constitutes interest on "obligations" of those public bodies.[49] Thus, interest on tax refunds is taxable, whether the taxes are those of the Federal government, a State, or a local subdivision of a State.[50]

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[40] *Barker, et al.* v. *Magruder* (D.C. Cir. 1938), 95 F. 2d 122, 20 AFTR 1072: The Bureau in an early ruling S.M. 4591, C.B. IV-2 160 (1925), has stated, that where under state law, a payment under a usurious contract is considered a payment on the principal, notwithstanding it was paid and received as interest, no income need be reported by the lender until the payment exceeds the principal. It is doubtful that the Commissioner would endorse this opinion today.

[41] *Edgar B. Terrell,* 7 B.T.A. 773 (1927).

[42] See, however, discussion in this chapter with respect to corporate bonds issued at a discount.

[43] 1954 IRC § 501; 1939 IRC § 101, exempting certain corporations from income tax does not provide that interest paid on obligations of such corporations shall be exempt from tax.

[44] 1954 IRC § 1461; 1939 IRC § 143(d), Reg. 118, 39.143-1(b).

[45] 1954 IRC § 36; 1939 IRC § 23(aa)(2).

[46] *Helvering* v. *Midland Mutual Life Insurance Company,* 300 U.S. 216 (1937), 18 AFTR 1140.

[47] *Nichols* v. *Commissioner* (6 Cir. 1944), 141 F. 2d 870, 32 AFTR 507.

[48] *Helvering* v. *Missouri State Life Insurance Company* (8 Cir. 1935), 78 F. 2d 778, 16 AFTR 473; *Manufacturers Life Insurance Company,* 43 B.T.A. 867 (1941) (acq.).

[49] For what constitutes an "obligation" in this connection, see page 1501.

[50] I.T. 1748 II-2 C.B. 92; I.T. 2210, IV-2 C.B. 43.

g. Interest on life insurance. If the proceeds of life insurance are held by an insurance company under an agreement to pay interest thereon (without diminution of the principal), such interest is treated as taxable income.[51] The interest is considered paid by the insurance company for the use of the face amount of the policy.[52] Prior to the enactment of the 1954 Code, any interest element in installment payments of the proceeds of insurance policies payable by reason of the death of the insured was exempt from income tax, regardless of whether the insured or the beneficiary had elected the option to take the installments.[53] The 1954 Act (Section 101(d)) provides that where the insured dies after the enactment date of the 1954 Code, the interest element in life insurance proceeds (in excess of the statutory exclusion) accruing after the death of the insured is to be included in the beneficiary's income. Dividends added to the installment payments of principal and payable out of earnings of the company are, of course, taxable as interest dividends.[54]

h. Interest on legacies paid under state law as remuneration for the delay in distribution of the legacy is taxable as interest income.[55]

i. Interest element in obligations issued at a discount. A discount obligation is an obligation which increases in value until maturity, and on which no interim payments are made by the issuer. The most familiar example of a discount obligation is the Series "E" War Bond. The discount on this type of obligation represents interest income. An accrual basis taxpayer picks up the increment in value of the bond each year as interest income. Cash basis taxpayers who do not elect under provisions of Sec. 454 (1954 IRC); (Sec. 42(b) IRC 1939) to accrue the discount annually pick up the entire discount as interest income in the year of the maturity of the bond.

Discount is part of the cost of borrowing money. Its existence is usually predicated upon the fact that the rate of interest on the obligation is less than the current market rate of comparable securities. Under this theory, discount represents nothing more than deferred interest, i.e., interest payable at the maturity of the bond. Based upon this theory, discount should represent ordinary interest income whether it is accrued annually or received in a lump sum on the sale or redemption of the obligation.

Under the 1939 Code a peculiar tax situation arose on the redemption of a discount obligation which met the requirements of Sec. 117(f) (1939 Code). Under Sec. 117(f), redemption of a bond having coupons attached or in registered form was deemed a "sale or exchange." Thus any gain or loss to the holder was considered a capital gain or loss. If the obligation was held for more than 6 months any amount received in retirement of the obligation in excess of the basis of the obligation was treated as a long term capital gain. If, however, the obligation did not meet the formal requirements of Sec. 117(f) (1939 Code) any gain or loss on redemption was treated as ordinary income or loss. The Tax Court in a case affirmed by the Sixth Circuit, *Commissioner* v. *Caulkins*,[56] held that discount received on retirement of a bond meeting requirements of Sec. 117(f) (1939 Code) could for tax purposes be reported as a long term capital gain if the obligation had been held for 6 months prior to retirement. The Commissioner acquiesced in the *Caulkins* decision but later issued a ruling, Revenue Ruling 119, 1953-14,2, stating that the acquiescence in the *Caulkins* decision "should be limited precisely to what was there decided under the particular facts of that case." Strangely enough, there was nothing "very particular" about the facts in the *Caulkins* case. The decision in the *Caulkins* case provided an unusual opportunity for tax minimization. Following the rationale of the *Caulkins* case, it was a relatively simple proposition to convert ordinary interest income into capital gains by issuing and redeeming discount obligations which met the requirements of section 117(f). Moreover, from the obligor's point of view, the loophole was almost equally attractive. It was obvious that the corporation issuing the discount obligation could, for tax purposes, amortize the discount over the life of the obligation even though no payment of interest was required until maturity.[57] Furthermore, it was not necessary that the obligation be originally issued in registered form or with interest coupons attached. The Court held that bonds converted to meet the requirements of section 117(f) before their retirement would be afforded capital gain treatment.[58]

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[51] 1954 IRC § 101(c); 1939 IRC § 22(b)(1).

[52] *United States* v. *Heilbroner* (2 Cir. 1938), 100 F. 2d 379, 22 AFTR 101.

[53] *Pierce* v. *Commissioner* (2 Cir. 1945), 146 F. 2d 388; Reg. 118 Section 39.22(b)(1)-1, Section 101(d); (1954 IRC).

[54] *Commissioner* v. *Winslow* (1 Cir. 1940), 113 F. 2d 418, 25 AFTR 381. It is fundamental that amounts received under life insurance or endowment policies, other than by reason of death of the insured, are taxable to the extent that they exceed aggregate premiums paid. I.R.C., Section 22(b)(2)(A). So-called "dividends" on unmatured policies that are a return of premium are not taxable. See Reg. 118, Section 39.22(b)(2)-1.

[55] *Wolf* v. *Commissioner* (3 Cir. 1936), 84 F. 2d 390, 17 AFTR 1306; cf. *Foster* v. *Commissioner* (5 Cir. 1942), 131 F. 2d 405, 30 AFTR 294.

Section 1232 of the 1954 Code closed the tax loophole provided by the *Caulkins* case. The House Ways and Means Committee Report on H.R. 8300 had this to say concerning the enactment of Section 1232 of the new Code.

> Under the existing law any gain realized from a corporate or Government Bond in registered form or with coupons attached is treated as a capital gain either if the bond is held to retirement or if the bond is sold or exchanged. Part or all of this gain, however, may represent a discount on the original issue which is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.
>
> Effective with respect to bonds issued after December 31, 1954, the Committee bill provides that any gain realized by the holder of a bond attributable to the original issue, discount will be taxed as ordinary income. This discount is apportioned over the entire period to maturity of bond and if the bond is sold prior to maturity, only a pro rata portion of this discount is attributable to gain realized by the seller. Any excess gain over the amount considered as ordinary income will be taxed as capital gain. This ruling is not applied to State and local government securities since interest income on these securities is free of tax. Rules for determining the original issue price are provided by the bill.

Section 1232 of the 1954 Code liberalized the provisions of Section 117(f) of the 1939 Code in one respect. Under the 1954 Code, retirement of an obligation issued subsequent to December 31, 1954, *regardless of the form of the obligation*, is deemed a "sale or exchange." Capital gain or loss results, but only to the extent provided by Section 1232. Obligations issued prior to January 1, 1955 must have been in registered form as of March 1, 1954 in order to be afforded capital gain treatment on retirement.

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[56] *Commissioner v. George Peck Caulkins* (6 Cir. 1944), 144 F. 2d 482; 32 AFTR 1233, affirming 1 T.C. 656, acq. C.B. 1944, 5.

[57] Reg. 118, § 39.22(a)-17.

[58] *Lurie* v. *Commissioner of Internal Revenue* (9 Cir. 1946) 156 F. 2d 436, 34 AFTR 1557.

The loophole closing provision of Section 1232 are entirely prospective in nature. The retirement status of obligations in registered form as of March 1, 1954 is still very much in doubt. One might guess that the Commissioner will now withdraw his acquiescence in the *Caulkins* case and press for a conflicting decision in another Circuit. It's highly probable that the Courts have not seen the last of this issue.

5. Suggested Procedures for Minimizing Taxes on Interest

Income received in the form of interest has long occupied a unique position in our tax structure, for by statute it is provided that such income may, if received through investments in certain types of securities, be entirely or partially exempt from federal taxation. Aside from such statutory exemptions certain legal opportunities exist for an individual to eliminate entirely or substantially to reduce taxes on interest income. The remaining portion of this chapter is devoted to a discussion of how to realize tax-free or partially tax-free interest income. The following procedures are discussed:

a. *How to realize tax-free income by investing in non-taxable or partially taxable obligations of the United States, its instrumentalities, possessions or territories.*

b. *How to realize tax-free income by investing in non-taxable obligations of a state, a political subdivision thereof, or the District of Columbia.*

c. *How to minimize taxable income by investing in obligations with interest in default.*

d. *How to minimize the receipt of taxable income by agreeing with a debtor that payments shall be considered principal and not interest.*

e. *How to cut taxable income from interest by assigning interest-bearing obligations to members of your family.*

Investing in tax-free or partially taxable obligations of the United States, its instrumentalities, possessions, or territories. In these days of all inclusive taxation, it is surprising to find that there still exist certain tax sheltered investments. It is the aim of this subsection to point out and discuss with you such investments. A good many of the securities discussed have either matured or been redeemed. They are nevertheless included in the discussion for reference purposes.

The provisions of the Internal Revenue Code providing for exemption from Federal income tax of interest on obligations of the United States, its instrumentalities, or possessions or territories, are found in Section 22(b) 4 (1939 IRC) (Sec. 103, 1954 IRC).[59] This section provides in the first sentence for the exemption from tax of interest on "obligations of the United States or its possessions" or "of a . . . territory," and of interest on obligations of corporations, which are instrumentalities of the United States. But in the last sentence the section provides as follows:

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[59] 1939 IRC § 25(a)(1)(2) provided that in cases where interest on obligations of the United States or instrumentalities of the United States was, pursuant to the statutes authorizing the issuance of such obligations, exempt from normal tax but not from surtax such interest should be allowed as a credit against the normal tax. The 1954 Code eliminated any distinction between normal tax net income and surtax net income in the computation of tax liability, and substituted therefore the term "Taxable Income" (1954, IRC § 63). The former credit provided by Section 25(a) of the 1939 Code for partially exempt bond interest in the computation of normal tax net income is now reflected in section 35 of the 1954 Code as a credit against the entire tax.

> In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit) to the extent they represent deposits made before March 1, 1941, and in the case of obligations of a corporation or organized under Act of Congress, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from the taxes imposed by this chapter;

Thus, quite apart from the individual Acts authorizing the issuance of the obligations, the Internal Revenue Code provides for a blanket exemption from tax of interest on the following types of obligations:

a. *Interest on obligations of the United States issued on or prior to September 1, 1917;*

b. *Interest on obligations of possessions of the United States or territories, whenever issued:* and

c. *Interest on postal savings certificates representing deposits made prior to March 1, 1941.*

The extent of taxability of interest on the following classes of obligations is determined by the provisions of the respective acts authorizing the issuance thereof:

1. *Interest on obligations of the United States issued after September 1, 1917;*
2. *Interest on obligations of instrumentalities of the United States, whenever issued;* and
3. *Interest on postal savings certificates representing deposits made on or after March 1, 1941.*

Section 4(a) of the Public Debt Act of 1941,[60] which was enacted February 19, 1941 and became effective March 1, 1941, provided that interest on obligations of the United States, its agencies, or instrumentalities,[61] issued on or after March 1, 1941, should not be exempt from Federal income tax to any extent. Consistent with section 22(b)(4) of the Internal Revenue Code, the Public Debt Act of 1941 did not, however, remove the exemption from tax of interest on obligations of a territory, possession of the United States, the District of Columbia, or any of their political subdivisions, agencies, or instrumentalities.

The following classification of tax-exempt interest may, therefore, be made:

a. Interest on obligations given an express exemption from tax by the Internal Revenue Code.[62]

1. Interest on obligations of the United States issued on or prior to September 1, 1917, namely, the Panama Canal Loan of 1961 (issued June 1, 1911) and Convertible Bonds of 1946-1947 (issued January 1, 1916-1917).

2. Interest on obligations (irrespective of when issued) of territories; posses-

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[60] 55 Stat. 7, 31 U.S.C. Section 742a.

[61] An exception was made in the case of obligations which the United States Maritime Commission or the Federal Housing Administrator had, prior to March 1, 1941, contracted to issue at a future date. In the case of such obligations, the interest may bear such tax exemption as the law (in effect at the time of such contract) authorizing their issuance permitted.

[62] 1954 IRC § 103; 1939 IRC 22(b)(4).

sions;[63] the District of Columbia; or any of their political subdivisions, agencies, or instrumentalities.

3. Interest on postal savings certificates representing deposits made prior to March 1, 1941.[64]

b. Interest on obligations, the tax-exempt character of which is determined by the acts under which they were issued.[65] Each of the following classifications of obligations issued prior to March 1, 1941 is under the provisions of acts authorizing issuance thereof, exempt from tax to the extent indicated. (By virtue of the Public Debt Act of 1941, all such obligations issued on or after March 1, 1941 [66] are fully subject to income tax.)

1. Interest on Treasury certificates of indebtedness is entirely exempt from income tax.[67]

2. Interest on Treasury bills (the discount at which issued) is likewise wholly exempt from income tax.[68]

3. Interest on Treasury notes is exempt from income tax only to the extent provided in the terms of issue:[69] (1) "National Defense Series" Treasury notes are fully taxable;[70] (2) Treasury notes of the regular series (issued from 1937 to 1940) are entirely exempt.[71]

4. Interest on United States Savings Bonds and Treasury Bonds is exempt from normal tax but not surtax.[72] However, interest on an amount of principal not in excess of $5,000 owned by any one individual is also exempt from surtax.[73]

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[63] For example, interest on Puerto Rican bonds is exempt. O.D. 368, 2 C.B. 94; O.D. 637, 3 C.B. 123. Interest on obligations of the Philippine Islands issued prior to March 24, 1934 is exempt. However, obligations of the Philippine Islands issued on or after March 24, 1934, are expressly made taxable by Section 9 of the Act of March 24, 1934, 48 Stat. 456, 463, designed to effect the independence of the Philippine Islands. See I.T. 3864, 1947-2 C.B. 17.

[64] In the case of deposits made prior to March 1, 1941, the interest is exempt, even though new certificates are issued after that date to the same certificate holder upon withdrawal of accrued interest or a portion of the principal. I.T. 3562, 1942-2 C.B. 76. However, if on the death of a depositor new certificates are issued to his estate or beneficiaries on or after March 1, 1941, this is considered a new deposit, and the interest thereafter accrued is taxable I.T. 3622, 1943, C.B. 98.

[65] See Reg. 118, § 39.22(b)(4)-4(a), which provides in part as follows: ". . . in the case of obligations issued by the United States after September 1, 1917, which include Treasury certificates of indebtedness, Treasury bonds and Treasury notes, and in the case of obligations of a corporation organized under Act of Congress, the interest is exempt from tax only if and to the extent provided in the acts authorizing the issue thereof, as amended and supplemented."

[66] With the exception of certain obligations of the United States Maritime Commission and the Federal Housing Administrator. See footnote 58.

[67] Reg. 118, § 39.22(b)(4)-4(a).

[68] *Ibid.* Any gain from the sale of Treasury bills issued after June 17, 1930 is also exempt. Section 5, Second Liberty Bond Act, 49 Stat. 20, 31 U.S.C. Section 754, as amended June 17, 1930.

[69] *Ibid.*

[70] I.T. 3475, 1941-1 C.B. 199.

[71] See Table of Tax-Exempt and Partially Taxable U.S. Obligations in Section 5 of this chapter.

[72] Section 7, Second Liberty Bond Act, 40 Stat. 290, 31, U.S.C. Section 747, as amended; Reg. 118, § 39.22(b)(4)-4(a).

[73] *Ibid.* Interest on bonds, notes, and certificates of indebtedness of the United States, issued prior to March 1, 1941, beneficially owned by a nonresident alien individual not engaged in business in the United States is wholly exempt from Federal income taxes. Section 3, Fourth Liberty Bond Act of July 9, 1918 (40 Stat. 845) as amended by Section 4 of the Victory Liberty Loan Act of March 3, 1919 (40 Stat. 1311). This applies to United States Savings

TABLE OF TAX-EXEMPT AND PARTIALLY TAXABLE U.S. OBLIGATIONS

Type of Security	Tax Status
Bonds	Interest is exempt from normal and surtax.
3% Adjusted Service Bonds of 1945*	
3% Conversion Bonds of 1946-1947*	
3% Panama Canal Loan of 1961	
2½% Postal Savings Bonds (38th to 49th Series)	
Treasury Notes—Regular Series	
2% Series B-1942*	
1¾% Series A-1942*	
1¾% Series C-1942*	
1½% Series A-1941*	
1⅜% Series B-1941*	
1¼% Series C-1941*	
1⅛% Series A-1943*	
1⅛% Series B-1943*	
1% Series C-1944*	
1% Series B-1944*	
1% Series C-1943*	
¾% Series A-1944*	
¾% Series A-1945*	
Other Securities	
Tennessee Valley Authority (Sec. 15, TVA Act of 1933)—2½% Bonds, Series A*; 2½% Bonds, Series B*	
2% Postal Savings System—certificates for deposits made before March 1, 1941	
Treasury Bills various issues—issued before March 1, 1941; noninterest bearing and issued on a discount basis*	
Federal Land Banks—various Farm Loan Bonds issued before March 1, 1941*	
Federal Intermediate Credit Banks—various Farm Loan Debentures issued before March 1, 1941*	
Commodity Credit Corporation	Interest is subject only to surtax.
1% Notes, Series E-1941*	
⅝% Notes, Series D-1941*	
¾% Notes, Series F-1943*	
Federal Farm Mortgage Corporation	
3¼% Bonds of 1944-1964*	
3% Bonds of 1944-1949*	
3% Bonds of 1942-1947*	
2¾% Bonds of 1942-1947*	
Home Owners' Loan Corporation	
3% Bonds, Series A-1944-1952*	
2¼% Bonds, Series G-1942-1944*	
1½% Bonds, Series M-1945-1947*	
⅝% Bonds, Series L-1941*	
Reconstruction Finance Corporation	
1% Notes, Series S*	
⅞% Notes, Series N*	
⅞% Notes, Series P*	
⅞% Notes, Series R*	

In determining the $5,000 limitation, the issue or purchase price rather than the redemption price is used.[74]

5. Interest on farm-loan bonds issued by Federal land banks and joint stock

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and Treasury Bonds as well, thus such bonds are wholly exempt from income tax if owned by nonresident aliens not engaged in business in the United States. I.T. 3262, 1939-1 C.B. (Part 1) 96.

[74] Mim. 6327, I.R.B. 1948-25-12975.

TABLE OF TAX-EXEMPT AND PARTIALLY TAXABLE U.S. OBLIGATIONS (*Cont.*)

Type of Security	Tax Status
Federal Home Loan Banks—various bonds issued before March 1, 1941*	Interest is subject only to surtax.
Federal National Mortgage Association—various bonds issued prior to March 1, 1941*	
United States Housing Authority 1⅜% Notes, Series B-1944* ¼% Notes, Series E-1941*	
Federal Housing Administration Mutual Mortgage Insurance Fund (issued after February 3, 1938 and before March 1, 1941) 3% Debentures, Series A 2¾% Debentures, Series B* 2¾% Debentures, Series E	
Housing Insurance Fund (issued after February 3, 1938, and before March 1, 1941) 2¾% Debentures, Series C* 2¾% Debentures, Series D	
U.S. Savings Bonds (issued before March 1, 1941) 2.9% Series D-1941* 2.9% Series D-1940* 2.9% Series D-1939* 2.9% Series C-1938* 2.9% Series C-1937* 2.9% Series B-1936* 2.9% Series A-1935*	Interest is exempt from normal tax. Interest is subject to surtax except portion attributable to principal not in excess of $5,000.
Treasury Bonds 4¼% Bonds of 1947-52* 4% Bonds of 1944-54* 3¾% Bonds of 1946-56* 3⅜% Bonds of 1943-47* 3⅜% Bonds of 1941-43* 3¼% Bonds of 1944-46* 3¼% Bonds of 1943-45* 3¼% Bonds of 1941* 3⅛% Bonds of 1949-52* 3⅛% Bonds of 1946-49* 3% Bonds of 1951-55 3% Bonds of 1946-48* 2⅞% Bonds of 1955-60 2¾% Bonds of 1960-65 2¾% Bonds of 1958-63 2¾% Bonds of 1956-59 2¾% Bonds of 1951-54 2¾% Bonds of 1948-51* 2¾% Bonds of 1945-47* 2½% Bonds of 1950-52 2½% Bonds of 1949-53* 2½% Bonds of 1948* 2½% Bonds of 1945* 2¼% Bonds of 1954-56 2¼% Bonds of 1951-53 2% Bonds of 1953-55 2% Bonds of 1948-50* 2% Bonds of 1947*	

* Indicates obligations have matured or have been redeemed.

land banks and interest on debentures issued by Federal intermediate credit banks are wholly exempt.[75] Interest on notes held by such banks and secured by first mortgages is likewise exempt from income tax.[76]

6. Interest on obligations of instrumentalities of the United States, other than those described in item 5, is generally exempt from normal tax but not from surtax.[77]

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[75] Reg. 118, § 39.22(b)(4)-4; Section 26 Federal Farm Loan Act of July 17, 1916, 39 Stat. 380, 12 U.S.C. Section 931, as amended.

[76] Reg. 118, § 39.22(b)(4)-3.

[77] For details see Table of Tax-Exempt and Partially Taxable U.S. Obligations in Section 5 of this chapter. Bonds issued under Section 15(c) of the T.V.A. Act of 1933, 48 Stat. 58, 16 U.S.C. Section 831n-3, are fully taxable. I.T. 3355 1940-1, C.B. 22. T.V.A. bonds issued under Section 15, 16, U.S.C. Section 831n, are fully exempt.

The preceding table[78] classifies United States obligations on the basis of (a) those on which the interest is wholly exempt from tax, (b) those on which the interest is subject only to surtax, and (c) those on which the interest is exempt from all taxes on an aggregate of $5,000 in principal in the hands of any one individual but subject to the surtax on the excess.

Under the Public Debt Act of 1942,[79] all dividends on stock of agencies or instrumentalities of the United States issued on or after March 28, 1942 are fully subject to Federal income tax.[80] Thus, only dividends on stock of instrumentalities issued prior to March 28, 1942 are exempt to any extent from Federal income tax. The exemption is granted by the acts authorizing the issuance of the stock.

The following list is a classification of such stock issued prior to March 28, 1942, based on whether dividends thereon are fully exempt, exempt from normal tax only or fully taxable. In each case the tax status is determined by the respective acts authorizing the issuance of the stock.

a. Agencies and instrumentalities, of which the dividends are fully tax-exempt:

1. Federal Land Banks.[81]
2. National farm loan associations.[82]
3. Federal Reserve Banks.[83]

b. Agencies and instrumentalities, of which the dividends are exempt from normal tax only:

1. Federal savings and loan associations.[84]

c. Agencies and instrumentalities, of which the dividends are fully taxable:[85]

1. Central Bank for cooperatives.
2. Production credit corporations.
3. Production credit associations.
4. Banks for cooperatives.

For taxable years beginning on or after January 1, 1944, taxpayers need no longer report on their returns interest that is wholly tax-exempt.[86] Interest that is subject to surtax but not to normal tax must, of course, be reported. The exemption from normal tax is effected by means of a credit.[87]

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[78] Adapted from J. K. Lasser, *Business Tax Handbook*, p. 438. New York: Simon and Schuster, Inc., 1950.

[79] Act of March 28, 1942, 56 Stat. 189, 31 U.S.C. Section 742a.

[80] Stock of an agency or instrumentality is considered issued at the time and to the extent that payment therefor is made to the agency or instrumentality. If an old stock is retired and exchanged for new stock of a different character or preference, the new stock is deemed issued at the time of the exchange, rather than when the old stock was paid for. Reg. 118, Section 39.22(b)(4)-2.

[81] Section 26, Federal Farm Loan Act of July 17, 1916, 39 Stat. 380, 12 U.S.C. Section 931.

[82] *Ibid.*

[83] Section 7, Federal Reserve Act of December 23, 1913, 38 Stat. 258, 12 U.S.C. Section 531. Dividends paid by member banks are, of course, fully taxable.

[84] Section 5(h), Home Owner's Loan Act of 1933, 48 Stat. 133, 12 U.S.C. Section 1464(h). For details as to the effect of the Public Debt Act of 1942 thereon, see I.T. 3589, 1942-2 C.B. 72.

[85] All of these agencies were organized under the Farm Credit Acts of 1933. See Section 63 thereof, 48 Stat. 267, 12 U.S.C. Section 1138c.

[86] 1954 IRC § 103; formerly Section 22(b)(4), of the 1939 Code as amended by Section 11(d) of the Individual Income Tax Act of 1944.

[87] 1954 IRC § 35; 1939 IRC § 25(a)(1)(2).

The method of reporting interest on United States Savings Bonds issued at a discount affords further opportunity for tax saving. If the individual taxpayer is on the accrual basis, he must report as income each year the annual increment in value.[88] If the taxpayer is on the cash basis, he does not in the absence of the election described below report the increment in value until the maturity of the bond, or the surrender of the bond before maturity.[89]

For taxable years beginning after December 31, 1940, the cash basis taxpayer may elect to treat all noninterest bearing obligations issued at a discount, whether or not they are government obligations, on the accrual basis; that is, he may treat the annual increment in value of such obligations as income each year.[90] If the taxpayer adopts this method of reporting, he must so elect with respect to all such obligations[91] that he owns[92] at the beginning of the first taxable year in which he exercises the election, and with respect to all such obligations thereafter acquired. The same method must be followed in succeeding years, unless the taxpayer procures the Commissioner's permission to change.[93] In the year when he makes the election, the taxpayer must report as income all increment in value of these obligations to that year.[94] Individual taxpayers may find it advantageous to adopt this accrual method of reporting in order to spread the income from obligations issued at a discount over the years, instead of being required to report such income in the year of redemption. However, the election should be made, if possible, in a low-income year since in that year all previously accrued income will have to be reported. Cash basis bondholders, who originally elected to report annual increment must continue to use that method when they exercise the option to hold Series E bond an extra 10 years. Permission must be obtained from the Commissioner to postpone taxability of the increment until the extended maturity date.[95]

Whether the individual is on the cash or the accrual basis, in the case of United States Savings Bonds or Treasury Bonds issued prior to March 1, 1941, interest on principal not in excess of $5,000 will, as already indicated, be exempt from normal tax and surtax. Each year he may designate the $5,000 among his holdings in United States Savings Bonds or Treasury Bonds that will be allowed tax-exempt interest.[96] To secure the greatest tax benefit he ordinarily should select for this purpose the $5,000 of bond principal that has the greatest interest yield.

For an accrual-basis taxpayer, or one who has chosen the accrual basis merely to handle his non-interest bearing obligations, the annual increment in value of any $5,000[97] of United States Saving Bonds (issued prior to March 1, 1941) that he selects is wholly exempt. If he is on the cash basis of reporting, he may select for exemption the entire amount of discount realized in any year through the redemption at maturity or through sale of any $5,000 of such United States Savings Bonds.[98] This procedure assumes that it is not to the taxpayer's advantage to utilize any of the $5,000 exemption on Treasury bonds issued prior to March 1, 1941.

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[88] Mim. 6327, 1948-2 C.B. 12.

[89] *Ibid.*

[90] 1954 IRC § 454; 1939 IRC § 42(b). Reg. 118, Section 39.42-6.

[91] In the case of noninterest bearing obligations of the United States, its possessions, or of a state, territory, political subdivision, or the District of Columbia issued on or after March 1, 1941 at a discount, with a fixed maturity date not exceeding one year from date of issue, the discount does not accrue until the bond is paid at maturity or is sold. IRC § 42(c). Moreover, such obligations are not capital assets, Section 117(a)(1); hence in the case of disposition, no allocation need be made between discount and proceeds referable to principal because all gain will be taxable as ordinary income.

[92] The election is not binding on a transferee of the obligations. Reg. 118, § 39.42-6.

[93] 1954 IRC § 454; 1939 IRC § 42(b), Reg. 118, § 39.42-6.

[94] *Ibid.*

[95] J. K. Lasser, *Your Income Tax*, p. 36, New York: Simon and Schuster, Inc., 1952.

[96] Mim. 6327, 1948-2 C.B. 12.

It was frequently advantageous for a taxpayer who had purchased in any one year prior to March 1, 1941 more than $5,000 principal amount of United States Savings Bonds (the maximum purchase permitted was $10,000 maturity value) to cash in less than $5,000 of the principal amount of such bonds in a year prior to maturity and hold the balance until maturity.[99] If this procedure was followed, all of the interest was realized tax-free. On the other hand, if the aggregate amount of such bonds was cashed at maturity, the interest on principal in excess of $5,000 was subject to surtax. The last of these bonds matured February 28, 1951.

c. Investing in tax-free obligations of a state, a political subdivision thereof, or the District of Columbia. Section 22(b)(4) of the 1939 Internal Revenue Code (1954 IRC Sec. 103(a)), gives a flat exemption from Federal income tax for interest upon "obligations of a state, territory, or any political subdivision thereof, or the District of Columbia . . ." Thus, irrespective of when they were issued, such obligations are wholly exempt from Federal income tax.

The principal questions that have been litigated in connection with the tax exemptions of obligations of a state and its political subdivisions are (1) what constitutes a "political subdivision" of a state; (2) what constitutes "obligations" of a state or political subdivision; and (3) what constitutes "interest" on obligations of a state or political subdivision thereof.

1. What constitutes a "political subdivision" of a state? Whether the local subdivision is a political subdivision within the meaning of the statutory exemption is determined by whether it performs customary, traditional, and essential governmental functions.[100] The test laid down in the regulations is whether the local subdivision has been delegated "the right to exercise part of the sovereign power of the State or Territory."[101]

Under the foregoing tests, bonds of special assessment districts, such as road, water, sewer, gas light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts, should qualify for the exemption.[102] The Port of New York Authority has been held to be a "political subdivision," and interest on its bonds is tax-exempt.[103] Similarly, the Triborough Bridge Authority has been held to be a political subdivision.[104] The Commissioner has ruled that interest on bonds issued by corporations formed by the state legislature to finance the acquisition of certain school sites and the erection of buildings thereon is exempt.[105] Similarly, interest on obligations of local housing authorities created pursuant to state law are exempt from Federal income tax.[106]

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[97] The $5,000 limitation applies to the purchase price of bonds—not the maturity value. Mim. 6327, 1948-2 C.B. 12.

[98] Thus, if the individual bought $5,000 in savings bonds (all issued prior to March 1, 1941) each year successively for ten years, the interest on each of the bonds would be wholly exempt at maturity. I.T. 3343, 1940-1 C.B. 21.

[99] See J. K. Lasser, *Your Income Tax*, p. 36. New York: Simon and Schuster, Inc., 1950.

[100] *Commissioner* v. *Shamberg Estate* (2 Cir. 1944), 144 F. 2d 998 32 AFTR 1295, cert. den. 323 U.S. 792; *Commissioner* v. *White Estate* (2 Cir. 1944), 144 F. 2d. 1019, cert. den. 323 U.S. 792, 32 AFTR 1316.

[101] Reg. 118, § 39.22(b)(4)-1.

[102] *Commissioner* v. *Shamberg Estate,* but cf. Reg. 118, § 39.22(b)(4)-1.

2. What constitutes "obligations" of a state or political subdivision?

a. The obligation does not have to be in any particular form so long as it is created by written agreement. The following have been held to be sufficient obligations to qualify for the exemption:

(1) Notes issued by a municipality in connection with the purchase of land.[107]

(2) A written agreement executed in connection with the purchase of real property.[108]

(3) An indirect obligation, where the corporation whose obligation was issued was formed as an agent of the state to facilitate borrowing by the state.[109]

However, an open account has been held not to be a sufficient obligation on the ground that an obligation does not exist unless there is at least some written instrument executed by the state or the political subdivision.[110]

b. The obligation can qualify for the exemption even though it is payable only out of a special fund, such as a special assessment on property owners whose property was improved with the money borrowed.[111]

c. The obligation must have some relation, however, to the borrowing power of the state or political subdivision. Thus, the following types of instruments have been held not to qualify:

(1) A condemnation award from a political subdivision of a state has no relation to the governmental borrowing power, and interest thereon is not exempt.[112]

(2) Non-interest-bearing warrants issued at no discount by a state for the purchase of goods, but subsequently purchased by a third party at a discount from the seller of the goods, do not qualify for the exemption. Accordingly, when the purchaser of a warrant receives full payment from the state, the difference between his purchase price and the face amount of the warrant is fully taxable income.[113]

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[103] *Commissioner* v. *Shamberg Estate,* see footnote 100.

[104] *Commissioner* v. *White Estate,* see footnote 100.

[105] I.T. 3772, 1945 C.B. 367.

[106] Since the local housing authorities are not considered instrumentalities of the United States, they do not fall within the scope of the Public Debt Act of 1941, see above, note 60. I.T. 3569, 1942-2 C.B. 68.

[107] *Commissioner* v. *Meyer* (2 Cir. 1939), 104 F. 2d 155, 23 AFTR 31.

[108] *Kings County Development Co.* v. *Commissioner* (9 Cir. 1937), 93 F. 2d 33, cert. den., 304 U.S. 559, 20 AFTR 384.

[109] *Norfolk National Bank* v. *Commissioner* (4 Cir. 1933), 66 F. 2d. 48, 12 AFTR 920; but cf. *Bess Schoellkopf,* 32 B.T.A. 88 (1935).

[110] *Kurtz Brothers,* 42 B.T.A. 561 (1940).

[111] *Bryant* v. *Commissioner* (9 Cir. 1940), 119 F. 2d 9: *Commissioner* v. *Pantarelli* (7 Cir. 1938), 97 F. 2d 793; *Commissioner* v. *Carey-Reed Co.* (6 Cir. 1939), 101 F. 2d. 602, 22 AFTR 489.

[112] *United States Trust Co.* v. *Anderson* (2 Cir. 1933), 65 F. 2d. 575, cert. den. 290 U.S. 683; *Holley* v. *U.S.* (6 Cir. 1942), 124 F. 2d 909, cert. den. 316 U.S. 685, 28 AFTR 863.

[113] *Parrish & Co.* v. *Commissioner* (5 Cir. 1945), 147 F. 2d 284, 33 AFTR 665. The state entered into no obligation to pay interest or discount.

(3) Interest on delinquent tax sale certificates is not exempt as interest on an obligation of a state or municipality.[114]

3. What constitutes "interest" on obligations of a state or political subdivision thereof?

a. Ordinary interest paid periodically and accrued interest payable upon redemption of the obligation are, of course, exempt interest within the meaning of the statute.[115]

b. Discount realized either upon redemption of the obligation or by sale prior to redemption is tax-exempt interest.[116] If a bond is sold prior to maturity, each holder may treat as exempt interest income that portion of the total discount which the number of days the obligation was owned by him bears to the total number of days from the date of issuance of the bond to its maturity.[117] Any gain in excess of the discount is not exempt,[118] and a loss in such circumstances may be taken into account.[119]

c. Premium does not constitute tax-free interest.[120] When a premium is paid upon redemption of a bond, it is not paid for the use of borrowed money but for the privilege of release from the obligation.[121] The amount of premium will be treated as taxable capital gain.[122]

d. Penalties provided for in bonds, payable in the event of default, are not tax-exempt interest.[123]

e. Certificates in lieu of interest; Where a municipality issued certificates in lieu of interest on its obligations, gain from the sale prior to maturity has been considered exempt interest.[124]

d. Investing in obligations with defaulted interest. There is considerable opportunity for tax-free interest, with no consequence other than reduction of basis, in the purchase of obligations that have interest in default. Obligations with interest in default are generally traded in "flat," that is, for a single price that includes both principal and accrued interest. If an individual purchases such an obligation, and interest accrued prior to the date of his acquisition is subsequently recovered, the interest will not be treated as income but as a return of capital reducing his basis for the obligation.[125] Thus, he may recover his entire basis for the obligation before realizing income. The rule is also applicable in the case of accrued interest on income bonds which are purchased "flat," that is, bonds on which the interest is payable only out of income or may be paid out of income at the discretion of the board of directors.[126]

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[114] *Wiltsie* v. *U.S.* (Ct. Cl. 1933), 3 F. Supp. 743, cert. den. 291 U.S. 664 12 AFTR 1107. The procedure followed in these cases is for certain individuals to purchase delinquent tax sales certificates (representing delinquencies in property taxes) from local counties or municipalities. The purchaser of the certificate is thereupon entitled to enforce his claim for the principal amount of the tax plus interest against the property owner. Any interest collected on such certificates is fully taxable. The obligation is not that of the governmental body.

[115] G.C.M. 21890, 1940-1, C.B. 85.

[116] G.C.M. 21890, see footnote 115.

[117] G.C.M. 10452, XI-1 C.B. 18; I.T. 2629, XI-1 C.B. 20.

[118] G.C.M. 10452, see footnote 117. Gain is the excess of the amount realized, less that portion of the discount to which the seller is entitled, over the basis of the obligation.

[119] G.C.M. 10452, see footnote 117.

[120] G.C.M. 21890, see footnote 115.

[121] *Ibid.*

[122] In case the obligation meets the requirements of 1954 IRC § 1232; 1939 IRC § 117(f). See *District Bond Co.*, 1 T.C. 837 (1943).

[123] *District Bond Co.*, see footnote 121.

[124] *Palm Beach Trust Co.*, 9 T.C. 1060 (1947), affirmed on other grounds (D.C. Cir., April 18, 1949), 174 F. 2d 527. But see *Lloyd* v. *Commissioner* (3 Cir. 1946), 154 F. 2d 643, cert. den. 329 U.S. 717, 34 AFTR 1119. In that case the taxpayer "almost simultaneously" purchased old bonds of a municipality, exchanged them for new refunding bonds with A and B coupons attached, detached the B coupons, sold the new bonds with A coupons attached, and then sold the B coupons to a different purchaser. The court held that the proceeds from the sale of the B coupons could not be considered tax-exempt interest, but must be considered as part of the sale proceeds of the entire transaction.

In the case of the purchase of such obligations with interest in default, only interest accrued prior to the date of purchase can be recovered as a return of capital. Any interest accrued subsequent to the date of purchase will, of course, be taxable as ordinary interest income.[127] However, even where the bonds are purchased prior to any accrual of interest, if the payment subsequently made by the debtor is designated a principal payment, it will be deemed a return of capital, rather than interest income.[128]

Opportunity for taking advantage of these rules is frequently present in insolvency reorganizations, such as those of railroad companies where the interest on the obligations of the debtor may have been in default for a considerable period. A bondholder who owns obligations on which interest is in default and who anticipates that a plan of reorganization will provide for the payment of defaulted interest should sell his obligations before the consummation date of the plan. He can then repurchase obligations of the debtor before the consummation date. Thereafter, if interest is paid under the plan, it would appear that any interest accrued to the date of his acquisition of the recently purchased obligations would be a return of capital rather than interest income.[129] If the reorganization plan is nontaxable and provides for issuance of securities in payment of interest accrued on the bonds, such securities have been held to be tax-free under Section 112(b)(3) even to the extent attributable to interest accrued subsequent to the acquisition of the bonds.[130] Likewise, cash adjustments representing interest accrued on new securities from the effective date of the plan are treated as a return of capital.[131]

The application of these rules will work to the disadvantage of individuals who purchase "flat" tax-exempt bonds with interest in default. Here, also, payment of any interest accrued prior to the date of purchase is not considered "interest" but a return of capital. The result is that the payment instead of being tax-free results in a reduction of basis of the bond, which will be reflected in taxable gain when it is sold.[132] Any payment of such defaulted interest that, together with prior principal payments, exceeds the basis of the bond will result in capital gain.[133]

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[125] *Erskine Hewitt,* 30 B.T.A. 962 (1934) (acq.); *Adrian & James, Inc.* 4 T.C. 708 (1945). Such interest paid to a nonresident alien, however, is subject to income tax withholding. See Special Ruling of Deputy Commissioner, dated October 7, 1944, reported in 455 Prentice-Hall Federal Tax Service par. 76349. The nonresident alien may subsequently file a claim for refund for the amount of the withholding tax after the close of the year.

[126] I.T. 3689, 1944-1 C.B. 65: *National City Lines* (D.C., Delaware 1952) 97 F. Supp. 283, 40 AFTR 599 Reversed (C.A. 3 Cir.) par. 72,500 P.H. 1952.

[127] *Adrian & James, Inc.*, see footnote 125.

[128] *Ibid.*

[129] "When bonds in default are bought 'flat' the price paid is not apportioned between principal and interest: and when they are sold, the consideration received is set off against the purchase price to determine whether the investment resulted in gain or loss, no part of the sale price is regarded as taxable interest." *Commissioner of Internal Revenue* v. *Carman* (2d Cir. 1951), 189 F. 2d. 363; 40 AFTR 703. See, also, the following rulings: Rulings of Commissioner of Internal Revenue dated November 15, 1944, reported at 443 C.C.H. Fed. Tax Serv. par. 6685; Ruling of Deputy Commissioner of Internal Revenue, dated May 4, 1942, reported at 424 P.H. Fed. Tax Serv. par. 66226.

[130] *William W. Carman* (2 Cir. 1951), 189 F. 2d 363, 40 AFTR 703.

[131] *William W. Carman,* see footnote 130.

From the tax standpoint, therefore, it is generally advisable to follow these rules with respect to the purchase and sale of defaulted bonds traded in "flat":

1. *In the case of taxable bonds:*

a. If an individual holds such bonds with interest in default, he should sell them before payment of the interest is made or before his legal right to a definite amount of interest is established. He will thereby avoid ordinary interest income.[134]

b. The individual may repurchase bonds with interest in default, in which case receipt of interest accrued prior to such purchase will constitute a return of capital rather than interest income.

2. *In the case of nontaxable bonds:*

a. If an individual owns tax-exempt bonds with interest in default, he should not dispose of the bonds prior to the receipt of the interest. Any interest received by him that accrued subsequent to the date of purchase of the bonds will be treated as tax-free interest.

b. An individual should not purchase tax-exempt bonds with interest in default. The payment of interest accrued prior to the date of purchase will be deemed a return of capital, which will reduce his basis and result in taxable gain upon the sale or redemption of the bonds.

In the case of bonds not in default, with current interest payable, the rules dealing with taxability of interest in the event of sales may be briefly stated as follows: If the bond is sold between interest dates, the agreement of sale will ordinarily specify an allocation of the sale proceeds between principal and interest based on the amount of interest accrued to date of sale. In the case of taxable obligations the portion of the sale price allocated to interest will be taxable as ordinary interest income to the vendor. When the vendee receives the full amount of interest, he excludes from his taxable income the portion of the interest he has advanced to the vendor, but he must report the remainder as taxable interest.[135] Interest receipts have no effect on the basis either of the vendor or vendee, and do not enter into the computation of gain or loss from the sale of the bond.

In the case of tax-exempt bonds, it is particularly important that the selling price allocate a proper percentage to interest. The vendor will get a tax exemption for the portion of the selling price allocated to interest. The remainder of the selling price will be taxable gain to the extent that it exceeds basis.[136] Any portion of the interest received by the vendee not allocated to the vendor, that is, not accrued prior to the date of sale will be tax-free.

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[132] *Clyde C. Pierce Corporation* v. *Commissioner* (5 Cir. 1941), 120 F. 2d. 206; *William H. Noll,* 43 B.T.A. 496 (1941); *R. O. Holton & Co.,* 44 B.T.A. 202 (1941).

[133] *William H. Noll,* see footnote 132. This assumes that the obligation meets the formal requirements of 1954 IRC § 1232; 1939 IRC § 117(f).

[134] The Commissioner up to this point apparently has not contended that the seller of bonds realizes interest income in such a case.

[135] See Sol. Op. 46, 3 C.B. 90; *L. A. Thompson Scenic Railway Company* 9 B.T.A. 1203 (1928) (acq.).

[136] See *Willcuts* v. *Bunn,* 282 U.S. 216 (1931).

Agreeing with the debtor that payments shall be considered principal and not interest. In the case of part payments on an interest-bearing debt, the question of whether the payments constitute interest or principal depends upon the agreement between the debtor and the creditor.[137] In the absence of agreement, the debtor can appropriate the payment to interest or principal as he pleases. If the debtor fails to make a designation, the creditor may designate the payment as interest or principal.[138]

Thus, an individual may reduce his taxable interest income in any year, by agreeing with his debtor that certain payments shall be considered principal. Such an arrangement, if bona fide, will be given effect for tax purposes. Similarly, in the absence of agreement and designation by the debtor, the individual may designate any payments as principal. Of course, an agreement that payments constitute interest may be evident, not only from a specific contract but from the course of dealing between the parties and other extrinsic evidence.[139]

In the absence of agreement or specific designation by either party partial payments on an interest-bearing obligation will normally be considered payments of interest.[140] This is on the theory "that in justice to the creditor partial payments should ordinarily be applied to the portion of the debt which does not draw interest, i.e., the unpaid interest, rather than to the interest-bearing portion, i.e., the principal.[141]

Where a bankrupt does not have sufficient assets to pay the principal of his obligations in full, no portion of partial payments made by him should be considered taxable interest.[142] Even in situations not involving insolvency or bankruptcy, lump sum payments in settlement of interest-bearing debts for less than the face amount of the debt are not allocable in part to interest.[143]

Assignment of interest-bearing obligations to members of the family. One way, of course, for an individual to cut his taxable income from interest as well as dividends, is to assign the under-lying security to another. Since the Revenue Act of 1948 has permitted the splitting of income between husband and wife,[144] it is no longer advantageous generally from an income tax standpoint to effect such assignments to a spouse. However, it may still be desirable for an individual to assign securities to other members of his family. This procedure, of course, may have estate tax advantages as well. To accomplish the tax-saving purpose, the assignment must effectuate a transfer of the income-producing property, rather than a transfer merely of the right to the income from the property.[145] The assignment must be complete and bona fide; the property may not remain subject to the donor's control.[146] Even in the case of a complete assignment of the obligation, interest accrued up to the date of the assignment is income to the donor, at least where the donee receives the interest in the year of the assignment.[147] The subject of family assignments for income tax minimization is treated in detail elsewhere in this book.[148]

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[137] *George S. Groves*, 38 B.T.A. 727 (1938).

[138] G.C.M. 2861, VII-1 C.B. 255, and cases cited therein.

[139] Cf. *Judson Mills*, 11 T.C. 25 (1948); *Hudson-Duncan & Co.*, 36 B.T.A. 554 (1937). The *Judson Mills* case involved a contract of purchase, the proceeds to be paid in installments. Since extrinsic evidence, including letters of the vendor, showed that a designated portion of the installment payment was intended as interest, the court so regarded it, even though the written contract itself did not refer to interest.

[140] *Theodore R. Plunkett*, 41 B.T.A. 700 (1940); affirmed (1 Cir. 1941) 118 F. 2d 644.

[141] G.C.M. 2861, see above.

[142] *Ibid.*

[143] *William Justin Petit*, 8 T.C. 228 (1947) (acquiesced).

[144] IRC Section 12(d). 1939 Code.

[145] *Helvering* v. *Horst*, 311 U.S. 112 (1940).

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[146] *Gouldman* v. *Commissioner* (4 Cir. 1948), 165 F. 2d 686, 36 AFTR 689; *Overton* v. *Commissioner* (2 Cir. 1947), 162 F. 2d 155, 35 AFTR 1427.

[147] *Austin* v. *Commissioner* (6 Cir. 1947), 161 F. 2d 666, cert. den. 332 U.S. 767, 35 AFTR 1350.

[148] See the later section in this book by Martin Atlas, "How to Operate Other Family Assignments and Agreements."

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Decedent's Income Under the 1939 and 1954 Codes

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Although Section 691 and certain other sections of the Internal Revenue Code of 1954 now contain the law governing the taxation of income transmitted by a decedent, a great deal of that law is identical with the provisions of former Section 126 of the Internal Revenue Code of 1939. Apart from the fact that numerous problems will continue to be considered and litigated under former Section 126 with respect to periods prior to the effective date of the 1954 Code sections dealing with decedent's income, a substantial body of law interpreting former Section 126 will continue to be applicable wherever relevant in considering the same provisions in the 1954 Code sections. Any discussion, therefore, which is to give complete treatment to the subject of decedent's income transmitted by death, must integrate the body of law developed under former Section 126 with the changes effected by the enactment of Section 691 and related sections of the 1954 Code. The 1954 Code sections dealing with this subject are Sections 691, 421(d)(6), Section 753 and Section 771(b)(4).

Section 126 of the 1939 Code was intended to furnish the method for taxing items of income which a decedent did not survive to collect. It was introduced in the Revenue Act of 1942 and represented a considerable departure from the previously existing method of dealing with income items of a decedent. In order to understand the scope and operation of former Section 126 and Section 691 and related sections of the 1954 Code, the previous statutory and judicial treatment of income items of a decedent antedating the Revenue Act of 1942 must be clearly understood. In seeking this understanding the basic pattern of approach must be: (1) What is taxed? (2) Who is taxed? (3) When is it taxed?

1. What is taxed is based on what is income in respect of a decedent under former Section 126 and new Section 691 and related sections and to what extent such income may be reduced by the estate tax deduction [(former Section 126(c) and Section 691(c), 1954 Code)], for such estate tax as has been paid because of the income item's inclusion in the estate.

2. Who is taxed depends upon who receives the right to the income item by bequest, devise, or inheritance.

3. When the item is taxed depends either upon the actual collection of the item by the person entitled thereto or upon disposition of the item by such person, under circumstances set forth in former Section 126 or new Section 691

and related sections constituting in effect a realization at the time of such disposition of the benefits of the income item.

1. Points to Consider

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2. How the Courts Have Interpreted Section 126, 1939 Code

Upon the death of a taxpayer, whether he was on a cash or accrual basis, a return called a decedent's final return must be filed for the period from the beginning of his tax year to the date of death. This is a short period return that requires no annualization and in which the method of accounting employed previously is continued. Prior to the Revenue Act of 1934, if a man were paid a salary on a monthly basis and died in the middle of the month, the accrued salary on the date of his death, if he was on the cash basis, became part of his estate and in effect became capitalized. Since a decedent's assets under the income tax law had an income tax basis equal to their value on the date of his death,[1] the unpaid salary, instead of having a zero cost basis, immediately received a cost basis of its actual value. When collected by the estate, therefore, no gain resulted since the amount collected equalled the statutory cost basis.[2] This resulted in the item avoiding income tax entirely.

Under the Revenue Act of 1934, it was provided (1939 Code, Section 42) that all items of income were accruable in the final return of the decedent whether he had been on the cash or accrual basis in his lifetime. The cash-basis taxpayer was thus changed into an accrual-basis taxpayer with respect to such final return. This change in the law brought about the imposition of income tax on the income item in the decedent's final return.

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[1] 1939 IRC § 113(a) 5.

[2] *Nichols* v. *U.S.*, 64 Ct. Cl. 241 (1927). See also *William G. Frank, Administrator*, 6 B.T.A. 1071 (1927); *E. S. Heller, Exec.*, 10 B.T.A. 53 (1928); *George Nichols, Exec.*, 10 B.T.A. 919 (1928); *Estate of A. Plumer Austin*, 10 B.T.A. 1055 (1928); *William K. Vanderbilt, Exec.*, 11 B.T.A. 291 (1928); *J. Howland Auchincloss, Exec.* 11 B.T.A. 947 (1928); *William P. Blodgett, Exec.*, 13 B.T.A. 1243 (1928); *Jackson B. Kemper, Adm.*, 14 B.T.A. 931 (1928). Compare *City Bank Farmers Trust Co., Exec.*, 29 B.T.A. 190 (1933).

However, it frequently resulted in serious inequity. The absolute accrual in the decedent's final return brought about the pyramiding of large amounts of income in these final returns that ordinarily would have been received over a period of time comprising more than one taxable period. To meet this problem, Sections 42 and 43 were amended and Section 126 was introduced into the law.[3]

The new statutory pattern excluded accrued items from a cash basis taxpayer's final return. Such items were to be reported when received either by the estate or by the person entitled to the items by bequest, devise or inheritance. These items were referred to as "income in respect of a decedent" and made thus taxable by prior Section 126. No distinction had been made under former Section 42 between accrual in ordinary course and accrual by reason of death. Thus income in respect of a decedent under prior Section 126 was intended to include such items as accrued in ordinary course or by death and which would have been properly includible under former Section 42 in the decedent's final return.

The taxpayer who was on the accrual basis was likewise given relief. Only such items as accrued in due course remained subject to Section 42 as amended, and the decedent's final return was no longer required to include items accrued only by reason of death.[4] This was motivated by the same inequity of piling up, in the final return of the accrual-basis decedent, items which might ordinarily have been included within more than one taxable period.

The cost-basis problem whereby the income item had previously had a cost basis of the value on the date of death was overcome by providing that such income items were to have the same cost basis and the same character in the hands of the estate or legatee as they would have had in the hands of the decedent.[5]

This brief résumé of the statutory background of Section 126 leaves little doubt that the intention of that section was to cover such income items as would have been accrued in the final return of a decedent under former Section 42. The scope of the application of Section 126 was thus delimited by the Treasury Department itself in its own regulations and rulings.[6] It is true that the application of this test would, under certain conditions, have permitted the receipt of items which might have been considered income if the decedent had lived without payment of any income tax thereon. If Section 126 had not been an outgrowth of the statutory and judicial history outlined above, there might be room for the contention that that section was intended to prevent any item from escaping income tax which might otherwise have been taxable to the decedent if he had been alive to receive it. No such broad interpretation of Section 126 would appear justified in the light of this history.

Nevertheless, this entire touchstone of interpreting questions arising under Section 126 has been thrown into doubt by the case of *O'Daniel* v. *Commissioner*,[7] which in effect rejected the requirement of an item having accrued prior to death in order to be taxable under Section 126. In the face of the statutory history reviewed above, the *O'Daniel* case decided that a right acquired by the decedent's estate from the decedent under Section 126 "is not necessarily a legally enforcible right but merely any right derived through his services rendered while living."[8] In other words, the court holds that any receipt which the decedent's estate may receive will be held taxable to the estate to the same extent as the receipt would have been taxable if the decedent had survived to receive it himself.[9] Until the United States Supreme Court has passed on this question, the law will remain uncertain. Appropriate and timely refund claims should be filed in each case where a tax has been imposed on an item that remained uncertain on the date of death and would not have been considered an accrued item under former Section 42.

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[3] § 134, Revenue Act of 1942.

[4] With reference to accrual of deductions under 1939 IRC § 43, see *Estate of George E. Howe*, 16 T.C. 1493 (1951).

[5] 1939 IRC § 126(a)(3). Thus, if income would have been long term capital gain to decedent, it would be similarly regarded in the hands of the estate or other person entitled to it.

[6] Bureau ruling, 1947 Prentice-Hall Fed. Tax Serv., par. 76,135.

[7] 173 F. 2d 966 (2 Cir. 1949).

The reenactment of the basic provisions of Section 126 as embodied in the 1954 Code in the face of the judicial interpretation theretofor placed upon the words, "income in respect of a decedent," in Section 126, may strengthen the position taken by the Commissioner and sanctioned by the *O'Daniel* case that any item of decedent's income will be taxed to the ultimate recipient as income in respect of a decedent, provided it would have been taxed to the decedent if he had survived to receive it and regardless of any question of accrual of the item during decedent's lifetime.[10]

The determination of what constitutes income in respect of a decedent will best be understood by a consideration of specific examples of different types of income receipts subsequent to a decedent's death.

3. The Sale of an Asset Before Death

Where a decedent had entered into a contract of sale to sell his house, which had a cost basis to him of $5,000., for $10,000., the collection by his estate of the $10,000. would clearly be income in respect of a decedent to the extent of $5,000. It would be capital gain and subject to capital-gains treatment just as it would have been if the decedent had survived.[11] The $5,000. item of income would constitute an asset in that amount in the decedent's estate, and in determining the deduction under old Section 126(c) and new Section 691(c) for estate taxes paid by reason of the inclusion of such asset in the decedent's estate, such deduction would be based on inclusion of 100 per cent of the value of the asset despite the effective taxation of only 50 per cent of the item by the method of taxing long term capital gains.[12]

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[8] *Id.*, at p. 968.

[9] The Income Tax Project of the American Law Institute has suggested that this broad rule be limited in its application to payments attributable to decedent's services, with all other rights to income subject to the historical test of accruability as set forth above. See Holland, Kennedy, Surrey, Warren "A Proposed Revision of the Federal Income Tax Treatment of Trusts and Estates—American Law Institute Draft" (1953) 53 *Col. L. Rev.* 316, 367-370.

[10] See Paul, *Studies in Federal Taxation* (3rd Series 1940) p. 434. "* * * where Congress uses language which has been construed by the courts it must be assumed to have employed that language in the sense in which the courts had previously construed it." See *Burnet* v. *Thompson Oil & Gas Co.*, 283 U.S. 301 (1931); *McCough* v. *Hershey Chocolate Co.*, 283 U.S. 488 (1931) rehearing denied 10/12/31.

[11] See footnote 5 above.

In *Rose J. Linde*[13] the theory that only an accruable item at decedent's death is subject to old Section 126 was rejected in a case when decedent had turned over property for sale, and where the sale took place after decedent's death. In that case a farmer who operated vineyards marketed his grapes by delivering them to a cooperative marketing association which processed the grapes into wine and other grape products and sold them for the members. Grapes were turned over to the association for processing and sale before decedent's death, and the proceeds were paid after his death. The Tax Court held that the proceeds were not income in respect of a decedent under prior Section 126 because the sale on behalf of decedent took place after decedent's death. The Court of Appeals for the Ninth Circuit reversed[14] on the ground that the time when title passed was irrelevant in a case where all steps for accomplishing the ultimate sale had been taken, even though no actual purchaser was identifiable at the moment of death nor was there any contract of sale outstanding with such purchaser. It would appear that this case would not be authority for taxing as decedent's income the profit on a sale of property which decedent had merely placed in the hands of a broker for sale. On the other hand if an agency to sell property were coupled with an interest of the agent so that it would be irrevocable, the *Linde* case would appear to be authority for treating the profit on the sale as a decedent's income item even though the entire sale took place after decedent's death.

4. The Decedent's Interest in a Partnership

a. Accrual of decedent partner's interest in partnership income to date of death. Under former law in the absence of special agreement, the death of a partner caused the termination of the partnership,[15] thus raising a question concerning the treatment of the deceased partner's interest in partnership earnings to the date of death. Prior to the 1934 Revenue Act amendments to Sections 42 and 43, a decedent partner's interest in the income of a partnership to the date of death was to be included in his final return, and this was so even if the partnership agreement provided that the partnership was to be carried on after the partner's death,[16] and whether the partnership was on the accrual basis or on the cash basis. But a cash-basis partnership was not transformed into one on an accrual basis because of the partner's death. The Revenue Act of 1934 did not alter these rules.

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[12] Revenue Ruling 55-481 I.R.B. 1955-31,10. Prior to the Revenue Act of 1951 only 50% of the $5,000. income would be subject to income tax. It had been ruled on this basis that the amount of the old Section 126(c) deduction would be based on the inclusion in the estate of only 50% of the value of the asset. See ruling 1945 Prentice-Hall Fed. Tax Serv. par. 76,190.

[13] 17 T.C. 584 (1951).

[14] 213 F. (2d) 1 (C.A. 9th 1954).

[15] Although death normally caused termination of a partnership under most state laws, some states permitted the avoidance of this result by specific agreement. See *Mnookin* v. *Commissioner*, 184 F. (2d) 89 (C.A. 8th 1950); *Girard Trust Co.* v. *Commr.* 182 F. (2d) 924 (C.A. 3rd 1950); *Estate of Hunt Henderson*, 155 F. (2d) 310 (5 Cir. 1946). But cf. *Davison* v. *Commr.*, 54 F. (2d) 1077 (2 Cir. 1931). By Revenue Ruling 144, 1953 C.B. 190, the Commissioner adopted a general policy for the effect of death on a partnership regardless of state law. Thus death would normally not cause termination of the partnership and the partnership was continued to the end of its fiscal year for tax purposes as if the death had not occurred, unless there was in fact an actual dissolution. The 1954 Code adopted this rule. 1954 IRC § 706(c)(1), 1954.

The Revenue Act of 1942 provided, in Sections 42 and 43, that a decedent's final return should report income based on decedent's customary accounting basis, and with respect to a decedent on the accrual basis, there did not have to be included items accrued only by reason of the taxpayer's death "except amounts includible in computing a partner's net income under Section 182." Since a cash-basis taxpayer was not specifically mentioned in this connection, the question presented itself whether the interest in a partnership of a cash basis taxpayer decedent had to be accrued in his final return.

The problem under consideration requires a clear understanding of the method of taxing partnership income generally under the 1939 Code. Under Section 182 of the 1939 Code, a partner was taxable on his distributive share of partnership income whether distributed to him or not. Thus, in the case of a cash-basis partner, he had to include items which he may not have actually received. When the partner died and the partnership was automatically dissolved, as of the date of death there was imputed to each partner, including the decedent, his distributive share of the firm profits. Under prior Section 126 income of a decedent was taxable to the estate when it was "not properly includible in respect of the taxable period in which falls the date of death or a prior period." Whether the accrued partnership income or loss was to be included in a cash-basis decedent partner's final return, which was the pre-1934 rule, depended upon whether the 1942 amendments, including Section 126, were intended to void the pre-1934 rule. It was held that a cash-basis decedent partner's interest in partnership income or loss to the date of death was properly includible in decedent's final return.[17] A study of both the decisions and the statutory pattern make it clear that a decedent partner's share in partnership earnings accrued to the date of death was taxable in the decedent's final return under old Section 126 and was not taxable as an income item to the decedent's estate.

Under the provisions of Section 753, 1954 Code, amounts includible in the gross income of a successor in interest of a deceased partner are declared to be income in respect of a decedent under Section 691. Thus to the extent that such amounts represent decedent's interest in the partnership's unrealized receivables and the amount paid in excess of the value of decedent's interest they will be treated as items of transmitted income. Under the 1954 Code, therefore, there is no need to go into the questions presented by the special accrual treatment of an interest in a partnership as contained in Sections 42 and 43 of the 1939 Code as stated above. Sections 451 and 461 of the 1954 Code in re-enacting former Sections 42 and 43 eliminated any exception with respect to accrual of an interest of a decedent in a partnership.

Furthermore the 1954 Code provides that unless a partnership is actually terminated the taxable year of a partnership will continue despite the death of a partner.[18] This enacts into the statute the position taken by the Treasury Department on this point. On the death of a partner the partnership year with respect to the deceased partner does not end before the end of the normal partnership year and this is so whether his interest in the partnership is actually liquidated before the end of the year or not. Under the new law, therefore, if a partner dies, his final return will not include income earned to the date of his death by a partnership whose year still continues, and the income will be taxed under new Section 691 to the estate or successor in interest when the partnership year including the date of death ends.

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[16] *Clarence B. Davison, Exec.*, 20 B.T.A. 856 (1930), affirmed (2 Cir. 1931) 54 F. (2d) 1077, 10 AFTR 1023; *Guaranty Trust Co.* v. *Commissioner*, 303 U.S. 493 (1938), and cases there cited.

[17] *Estate of Hunt Henderson* (5 Cir. 1946), 155 F. (2d) 310, 33 AFTR 719.

b. Effect of various types of post-death provision in partnerships. Partnership agreements frequently contain a provision whereby the decedent's interest in the partnership passes to the survivors in return for stipulated payments to the decedent's estate or to his widow. Under the 1939 Code upon the partner's death, the payments by the surviving partners had to be included in the income of the estate or the widow to the extent that they were attributable to the earnings of the partnership accrued only by reason of his death.[19] The income reflected by the payments, to the extent they were not so attributable, was not taxable as income transmitted by a decedent. In other words, any increase in the value of assets of a partnership was not considered gain under Section 126 in this type of situation. It must be borne clearly in mind that the reference to the accrual of a deceased partner's interest in partnership income to the date of death referred to partnership income which had reached the stage of accrual within the partnership, and did not refer to the accrual of decedent's rights in the partnership and therefore to unaccrued income that it later collected.

The 1954 Code adopts a similar approach so that that portion of amounts paid which represent increased value of the assets of a partnership as of the date of death will not be subjected to income tax to decedent's estate or to the successor to his interest except that the estate or successor in interest will be taxed on amounts paid for unrealized receivables.[20]

In mercantile partnerships where by agreement payments are to be continued for a period of time after a decedent's death in favor of his estate or beneficiary, such estate or beneficiary is treated under the 1954 Code as a partner and taxable with respect to income to the estate or beneficiary.[21] To the extent that such contract right to income after the partner's death is included as an asset of value in the estate,[22] the Section 691(c) deduction will be allowed for estate tax paid on the value of the right to such income. However, it appears that such 691(c) deduction will not apply to a decedent's interest in substantially appreciated inventory, since this is not treated as a right to income but part of his partnership interest. Further, it should be noted that this right to the 691(c) deduction applies only to payments made with respect to decedents dying after December 31, 1954.[23]

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[18] 1954 IRC § 706(c)(1).

[19] T.D. 5459, 1945 C.B. 193, amending the Regulations under 1939 IRC § 126.

[20] 1954 IRC § 736(b).

[21] 1954 IRC § 736(a).

[22] 1954 IRC § 753.

[23] 1954 IRC § 771(b)(4).

It has been particularly common in personal service partnership agreements to provide that in case of the death of a partner the surviving partners will pay the decedent's estate or beneficiary a percentage of partnership profits for a period after death.

Such a provision aims at avoiding difficult and complex accountings where allocation of fees for work in process and of expenses allocable thereto must be made for periods before and after death. It is generally recognized that the efforts of a decedent partner before death may have contributed substantially to the work later accomplished. Further, this continued participation in profits may also be the vehicle for paying off decedent's interest in capital or tangible assets.

Prior to the Revenue Act of 1934, where a decedent was entitled to share in fees of a personal service partnership that were collected after his death, such fees escaped income tax since they were regarded as part of the corpus of the decedent's estate. When the estate collected the item, it was considered to be simply a realization of the value of the item which had already become a corpus asset of the estate.[24] Where the successor firm paid a percentage of the profits in place of a share of the fees accrued to date of death, the same result was reached.[25] In this fashion, income escaped taxation unless the surviving partners could be held taxable thereon. By reason of the termination of the partnership on death, the Treasury succeeded in asserting that the payments by the successor firm were on account of the purchase price of decedent's interest in the firm. The surviving partners were thus subjected to income tax on the entire income of the successor firm, which included the amounts paid to decedent's estate.[26]

Customarily, the provisions in such agreement were declared to be in full payment of the decedent's interest in the firm. Such provisions helped reenforce the Treasury's contention that a purchase was being made. A portion of the payments quite clearly represented repayment of the interest of decedent for work in process, but this point was disregarded. Since the firm terminated on a partner's death, payments by the survivors were considered a purchase and the survivors were subjected to income tax on the income thus paid to the decedent partner's estate. The estate paid no income tax until the value of the right to the payments as established for estate tax purposes was received. Any amounts received in excess of such value would be taxed both to the surviving partners and to the decedent partner's estate. By the provisions of former Section 126 that part of such payments was declared to be taxable income to the estate, which represented decedent's share of work in process and receivables accrued to the date of his death.[27] The theory of a sale was quite at odds with reality as far as such work in process and receivables were concerned. The surviving partners owed a duty to account to the decedent's estate for the value of such items in the absence of any agreement. As to these items, the surviving partners substituted specific payments, whether liquidated or unliquidated, in place of this obligation owing to the decedent partner's estate. This, in substance, was a type of executory accord and satisfaction. It seemed quite unfair for the survivors to pay an income tax on such amounts under the circumstances. Since such items became taxable income to the estate under Section 126, there seemed to be no justification for injecting the fiction of a purchase and sale.

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[24] *Nichols* v. *U.S.*, 64 Ct. Cl. 241 (1927).

[25] *City Bank Farmers Trust Co. Excr.*, 29 B.T.A. 190 (1933).

[26] *W. Frank Carter*, 36 B.T.A. 60 (1937); *Estate of Bavier C. Miller*, 38 B.T.A. 487 (1938); *Hill* v. *Commissioner* (1 Cir. 1930) 38 F. (2d) 165, 8 AFTR 10152; *Pope* v. *Commissioner* (1 Cir. 1930) 39 F. 2d 420, 8 AFTR 10523. Compare: *Bull* v. *United States*, 295 U.S. 247 (1935), 15 AFTR 1069; *McLennen* v. *Commissioner*, (1 Cir. 1942) 131 F. (2d) 165, 29 AFTR 488.

[27] See *Helvering* v. *Enright* 312 [U.S. 636 (1941)], 25 AFTR 1213, which held work in process accruable in decedent's last return under 1939 IRC § 42.

Even with respect to payments in excess of the value of work in process and receivables, there was no basis for the argument that a sale and purchase took place. There was really nothing being sold except possibly such items as furniture and books. Death had extinguished anything that could be sold and the mere recognition of long association of the partners or other reasons for giving a participation in profits did not justify changing the situation into a sale. In effect, the partners, when alive, bought from one another the assurance of their estate's participation in the profits for a stated period and they paid for it with the promise to do the same if they survived. No actual purchase was truly intended.

The 1954 Code specifically treats amounts paid in excess of a partner's interest as a distributive share of partnership income if the amount paid is geared to partnership income or as a guaranteed payment if not determined with reference to partnership income.[28] In either event the recipients, that is, the estate or the beneficiary will be taxable on the income while the surviving partners will not be taxed on the amounts paid out, and this is true regardless of the period of time during which payments may be continued. Thus the 1954 Code has put an end prospectively to the purchase and sale theory.

5. The Sale of Stock by Estate to Surviving Stockholders

In close corporations, it is not uncommon for the stockholders to enter into an agreement with the corporation or with other shareholders whereby the surviving shareholders agree to purchase and a deceased shareholder agrees that his executors will sell his stock in the corporation at book value or any other stated price. Where the decedent's original cost basis was very low and the purchase price was substantially in excess of that cost basis, the question arose whether Section 126 would result in taxing to the estate the gain measured by the difference between the original cost and the purchase price. It was ruled that Section 126 would not be applied to such accretion in value to the date of death.[29] Consequently, in the ordinary case the sale of the stock resulted in no gain since the value on the date of death was the cost basis of the stock to the estate, and such value was ordinarily the purchase price under the agreement. The rule above stated would be the same whether the other stockholders agreed to buy the decedent's stock or whether the agreement provided that the corporation would purchase the decedent's stock. It would appear that the 1954 Code provisions would result in similar treatment.

In the case of a close corporation where the surviving stockholders or the corporation, pursuant to an agreement, are given an option to purchase decedent's stock at a stated price, the above ruling would similarly apply if the option is exercised and an amount is received substantially in excess of the decedent's original cost basis. In the case of such option there would seem to be no question of any possible application of prior Section 126 or new Section 691.

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[28] 1954 IRC § 736(a).

[29] 1945 Prentice-Hall Federal Tax Service, par. 76,295.

In the case of a right of a decedent stockholder's estate to call upon the surviving stockholders or the corporation to buy the stock if the executor of the decedent so elects, and if the election is made and a sale follows, it would seem that the situation should result in no different treatment than would apply in the case as above of a binding agreement by the decedent and the survivors or the corporation, requiring the survivors or the corporation to buy and the decedent's executor to sell the stock at a stated price.

6. Dividends on Stock

The declaration of a dividend creates a debt between the declaring corporation and the stockholder. The debt is payable to the person who owns the stock on the so-called date of record. A dividend declared before death and payable to stockholders of record after death had been held not to be accruable in a decedent stockholder's final return under former Section 42.[30] In deciding this case, the Supreme Court of the United States regarded the record date as determining what person was actually entitled to the dividend. Therefore, the dividend did not accrue until such date.

Where the record date of a dividend follows death, under the accrual theory discussed above, it would seem that the dividend was not "income in respect of a decedent" under former Section 126, since the dividend was not accruable under former Section 42. In the decedent's estate tax return, only the stock would be listed. The value of the stock would reflect the dividend since the dividend was already declared on date of death and it would be considered cum dividend on that date. This means that if the stock were sold on that date, the right to the dividend would pass on the sale. When the estate collects the dividend, it would be taxable income to the estate since the dividend, as such, not being separately valued in the estate has a zero cost basis. It is this latter reason which would make the dividend taxable and not the provisions of former Section 126. As a result, the estate tax deduction under prior Section 126(c) and new Section 691(c) discussed below, would not be allowed as a deduction to the person who includes the dividend in his income tax return; however, since the estate tax value of the stock reflects the dividend and such estate tax value thereby sets up a higher cost basis for the stock, upon a subsequent sale of the stock the estate or legatee would receive the tax benefit of such higher cost basis.

In the present situation, as indicated above, the application of the accrual theory does not avoid tax on the dividend. However, the accrual theory would result in the denial of a Section 126(c) or Section 691(c) deduction. In view of the discussion above it is entirely possible that the accrual theory would not be applied even in this case both under the 1939 Code and the 1954 Code, with the result that the dividend declared before decedent's death and payable on a record date after decedent's death would be income in respect of a decedent. To the extent of the value of the dividend as reflected in the cum dividend quotation of the stock on the date of decedent's death prior to the record date there would be a 126(c) or 691(c) deduction.

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[30] *Estate of Putnam* v. *Commissioner*, 324 U.S. 393 (1945), 33 AFTR 599.

Of course, a dividend on which the record date precedes the date of death will be clearly taxable under prior Section 126 and new Section 691. It is to be noted that the date of payment of the dividend is not a relevant factor in this discussion.

It is clear that the estate or beneficiary upon receipt of dividends declared prior to death of the decedent would be entitled to the dividend exclusion and dividend received credit under Sections 116 and 34 of the 1954 Code. The question presents itself whether the 691(c) deduction with respect to the estate tax occasioned by such dividends would reduce the dividends received credit, that is, whether the amount of dividends for purposes of the credit would be the actual amount received or the amount received net after giving effect to the 691(c) deduction. It would appear clear that since the 691(c) deduction is a separate deduction there is no reason for reducing the total of dividends received for purposes of the credit.

7. Interest on Bonds or Other Debts

Since interest accrues from day to day, interest on bonds or other indebtedness accrued to the date of death is taxable to the estate when received. The increase in value of U.S. Government "E" bonds would accrue in the same fashion as interest except that such accrual would not be on a day to day basis like ordinary interest, but would be the increase up to the amount of the redemption value within the month in which the death occurs. The increment on certain types of capital appreciation bonds would also be regarded as accruing like interest even though the increment is collectible only if the bond is held to maturity. "Original Issue Discount" on issuance of bonds would be taxable to the estate or beneficiary in the same way as if it had been received by the decedent.[31]

U.S. Government "G" bonds provide for redemption on death at par. Unless the bond is held until the current interest payment falls due, no accrued interest is collectible. It has been held therefore that no interest accrual to date of death is returnable in decedent's estate tax return.[32] However the interest is taxable to the estate when received, if held to the interest date.

8. Trustee's or Executor's Commissions

Where a decedent has become entitled, as trustee or executor, to commissions pursuant to court decree, such commissions, when paid after the death of the decedent, are clearly within prior Section 126 and new Section 691 and taxable to the estate.[33] Where death occurs before the decedent has completed his duties as executor or trustee the commissions to which he may ultimately become entitled have clearly not reached the definitive stage to be considered accrued items. In the absence of the *O'Daniel* case previously discussed, and utilizing the test for application of old Section 126 and new Section 691 of what items would have been accrued under former Section 42, there would be strong ground for the proposition that such a contingent right to commissions to be determined in the future would not be an item of decedent's income. The result would be that the contingent right to commissions would be valued for estate tax purposes, and when paid, only the amount in excess of the estate tax valuation would be subjected to income tax outside the scope of old Section 126 and new Section 691. However for the reasons discussed above such commissions will probably be treated as income in respect of a decedent.

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[31] 1954 IRC § 1232.

[32] *Estate of King*, 18 T.C. 414 (1952).

[33] *Estate of Fred Basch*, 9 T.C. 627 (1947)

Where all the duties of the executor and trustee have been completed and death occurs before a court approves and decrees the payment of commissions, this intermediate stage may have more in support of taxability under prior Section 126 and new Section 691 than the previous case, where death occurs prior to the completion of duties as executor or trustee. In such a case, the test might be laid down that in the absence of any complicating features in the estate or trust, and where the statute or the trust instrument specifically prescribes the compensation to be paid, the mere requirement of court approval of the payment of commissions, which might reasonably be assumed, should not preclude considering the item as in substance accrued on the date of death. The discussion under this heading should be compared with that dealing with insurance renewal commissions below.

9. Insurance Renewal Commissions

The right of a decedent to insurance renewal commissions with respect to insurance for which decedent acted as agent, depends upon two contingencies. The first is that the insured does not die during the period when such renewal commissions would otherwise become payable. The second is that the insured will not give up the insurance and thus stop the payment of premiums. The serious uncertainty as to whether the renewal commissions will be paid is evidenced by the fact that among insurance agents a market has grown up for insurance commissions and they are dealt with at a substantial discount. It would seem, therefore, that under no hypothesis could insurance renewal commissions be considered accruable under former Section 42, and the courts have so held.[34] Nevertheless, the Tax Court has indicated that insurance renewal commissions might be considered as within the scope of prior Section 126.[35] Only the acceptance of the principle of the *O'Daniel* case could bring about this result. The Senate Report on Section 691 of the 1954 Code refers to the case of insurance renewal commissions as a typical item of decedent's income.[36] Consequently it may be difficult to overcome the claim that such commissions are items of decedent's income at least with respect to new Section 691.

10. Post-Death Bonuses, Widow's Pensions, Retirement Annuities, Joint and Survivor Annuities

Where an employee has customarily received bonuses at the end of a given year of work, it has been held that such bonuses will be taxable income under prior

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[34] *Seattle First National Bank* v. *Henrickson;* 24 F. Supp. 256, 32 AFTR 121. (W.D. Wash. 1938) appeal dismissed (9 Cir. 1939) 100 F. (2d) 1015.

[35] *Thomas F. Remington,* 9 T.C. 99 (1947). See also Informal Ruling to the same effect 1952, CCH Fed. Tax Serv., par. 6221.

[36] Sen. Rep., on H.R. 8300, page 373.

Section 126 to the employee's estate when paid after his death, even though on the date of death there was no assurance that a bonus would in fact be paid or, if paid, what the amount of the bonus would be.[37] As indicated above, this result is contrary to the purpose of old Section 126 as reflected in its statutory history and development. It may be that when the courts are faced with the question, they will not include, as a Section 126 item, a bonus which was never paid regularly prior to death or which is paid for the first time after death. In this connection, it should be noted that where a corporation continued the salary of an employee for a period of time after his death by paying the same to his widow, it had been ruled that what the widow received was in the category of a pension and was not taxable income.[38] A later ruling[39] required all such payments received after 1950 to be included in the widow's taxable income. This latter ruling provoked enactment of Section 22(b)(1)(B) of the 1939 Code which excluded from gross income of the beneficiaries of a deceased employee for the year 1951 and thereafter, the sum of $5000. from any one employer provided such payment was made under an express contract that made the payment by the employer a legally binding obligation. Section 101(b) of the 1954 Code modified this provision by allowing an aggregate of $5000. with respect to any deceased employee and also eliminated the requirement of a pre-existing contract to make the payment or payments.

Where the widow of a deceased commissioned officer received a lump sum payment representing compensation for active service in the military or naval forces of the United States, such compensation was held to be income to the widow, but she was held entitled to the $1500. exclusion from gross income that the deceased officer would have been entitled to under Section 22(b)(13)(A) of the 1939 Code.[40]

Where an employee received an annuity pursuant to a pension plan approved under 1939 IRC § 165, which was continued in favor of his designee after his death, prior Section 126 would not be applied because 1939 IRC § 165(b) specifically provided that such payments were to be taxed to the distributee as annuities under 1939 IRC § 22(b)(2). It follows, therefore, that the person who receives the annuity on which income tax is paid under 1939 IRC § 22(b)(2) has no right to a deduction under prior Section 126(c) for estate tax which was paid upon the annuity.[41]

Under the 1954 Code if an annuity contract is purchased by an employer for an employee under an approved plan under 1954 IRC § 404(a)(1) and such annuity is continued in favor of his designee after his death, the amounts received by such designee will be taxed under the annuity provisions of 1954 IRC § 72. Since such an annuity is freed of estate tax by 1954 IRC § 2039(c), no question arises with respect to the Section 691(c) deduction.

Both the 1939 and 1954 Codes provide that if a payment under an approved plan is made to a payee by reason of an employee's death within one taxable year of the payee, then the amount received exceeding contributions by the employee would be taxable to the payee as long term capital gain.[42] Under the 1954 Code, however, such payment not being subject to estate tax,[43] no Section 691(c) deduction is available.

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[37] *O'Daniel* v. *Commissioner* (2 Cir. 1949), 173 F. (2d) 966. Compare *Estate of Fred Basch*, 9 T.C. 627 (1947) where decedent was entitled to a bonus measured by a percentage of profits under his contract of employment. The Court held that the bonus when received was taxable to the estate under § 126. See also *Estate of Emil A. Stake*, 9 T.C. 99 (1947). For bonus payments to a widow in community property states see I.T. 3931, 1948-2 C.B. 87.

[38] I.T. 3329, 1939-2 C.B. 153.

[39] I.T. 4027, I.R.B. 1950-21-13, 447, page 2.

[40] I.T. 3801, 1946-1 C.B. 109.

[41] Bureau Ruling, 1947 Prentice-Hall Federal Tax Service, par. 76,135.

Prior to the amendment of 1939 IRC § 22(b)(2) by Section 303(a) of the 1951 Revenue Act, the surviving annuitant under a joint and survivor annuity continued to declare the amount of income determined under the 3% rule. Thus, assume that a joint and survivor annuity were purchased for $100,000., with provision for payments of $5000. annually during the lives of the annuitant and his wife. If the annuitant had received ten payments he would have had $3000. of income in each year under the 3% rule and a return of capital of $2000. Upon the death of the annuitant after ten payments the annuitant's wife would continue during her lifetime to treat $3000. of the annual payment as income and the balance of $2000. as return of capital. When the total capital had been recouped, which would under the above assumption take fifty years based upon the amount received by the annuitant and his widow combined, then each annual payment would be entirely income.

The 1951 amendment provided that if the death occurred after December 31, 1950 and the value of the annuity was part of decedent's gross estate, the consideration for purposes of the 3% rule would change with respect to the surviving annuitant from the original consideration to the value of the annuity for the survivor as determined for estate tax purposes. Thus in the above example, if the estate tax value of the annuity were fixed at $50,000., the surviving wife would report only $1500. of the $5000. annual payment as income and $3500. as return of capital.

Under these conditions the subjection of the surviving annuitant to income tax would be based entirely on 1939 IRC § 22(b)(2) and no deduction for estate tax under prior Section 126(c) would be available because the income tax imposed did not derive from Section 126(a) covering income in respect of a decedent.[44]

The 1954 Code retains the stepped-up basis rule for a survivor annuitant, but in view of the abolition of the 3% rule, utilizes this new basis where the primary annuitant died after 1950 and before 1954 for purposes of the exclusion ratio under the life expectancy rule. In such cases the survivor's "investment in the contract" for purposes of computing the annual exclusion under the life expectancy rule is determined by the value of the survivor's interest under the contract, which is the date of death value less any amounts recovered by the survivor tax free. The "annuity starting date" in such case would be January 1, 1954 or the first day of the first period in which the survivor received an annuity payment under the contract, whichever is later. To follow out the foregoing example, assume that the primary annuitant died on January 1, 1952 and that on January 1, 1954 the survivor had received two full annual payments. There would have been a return of capital of $3500. per year for two years or $7000. Since the date of death value of the annuity is as indicated above, $50,000., this would leave $43,000. as investment in the contract. If the survivor's life expectancy were ten years on January 1, 1954, the proportion of each annual payment of $5000., which would be excluded from the contract, would be

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[42] 1939 IRC § 165(b), 1954 IRC § 404(a)(2).

[43] 1954 IRC § 2039.

[44] Similarly, where a retired United States civil service employee has received annuity payments in excess of his contribution to the Civil Service Retirement Fund, the amount of the unexpended balance in the fund paid to the administrator of his estate upon his death is taxable income to the estate. However the income being subjected to tax under no other particular section of the Code would be taxable as income in respect of a decedent under 1939 IRC § 126(a), and 1954 IRC 691(a). I.T. 3744, 1945 C.B. 192. See also I.T. 3949, I.R.B. 1949-9-13,071, Prentice-Hall Federal Tax Service, par. 76,243 dealing with annuities under the Civil Service Retirement Act.

$$\frac{43{,}000}{50{,}000\ (10 \times \$5000.)}$$

If the primary annuitant dies after December 31, 1953, there is no provision for any step-up in basis. The annuity starting date is January 1, 1954. As of that date a special Joint and Survivor Table for Life Expectancy (Table 2, T.D. 6118) determines the joint life expectancy of both annuitants and the exclusion ratio for the primary annuitant remains constant until the survivor's death. Thus, continuing the above example, if the primary annuitant died on June 30, 1954, the amount of taxable income in the annuity payments received by the primary annuitant from January 1, 1954 to June 30, 1954 would be based upon the Joint Life Expectancy Table determination as above. The same exclusion would be applicable to the surviving annuitant.

The 1954 Code has replaced the step-up in basis to the surviving annuitant by a deduction similar to that provided for in 1954 IRC § 691(c), but which is spelled out in 1954 IRC §§ 691(d)(1) and 691(d)(3)(A). This deduction is based on the estate tax attributable to the value for estate tax purposes of the annuity in the primary annuitant's estate. The deduction spreads this estate tax value over the life of the survivor, so that if the survivor reaches his or her life expectancy it will be fully allowable. However, no deduction is allowed beyond the survivor's life expectancy nor is there any permissible adjustment or allowable deduction if the survivor dies before the end of the life expectancy. The net value for estate tax purposes is computed by a determination of the excess of the value of the annuity at the deceased annuitant's death over the total amount properly excludable from the survivor's gross income during the latter's life expectancy and then multiplying this excess by the ratio which the estate tax value bears to the value of the annuity at the annuitant's death. It is possible that these two latter values may differ because the annuity may have been subjected to estate tax only in part where, for example, the survivor had paid part of the consideration. This special deduction is available only where the primary annuitant died after January 1, 1954 or if the survivor received the first payment under the annuity on a date later than January 1, 1954.

A joint and survivor annuity which has no refund guarantee feature will, in the case of husband and wife being the primary and secondary annuitants, qualify for the estate tax marital deduction.[45] Because no other person has any interest in the annuity contract beyond the lifetime of the surviving spouse, this type of contract is not a "terminable interest" for marital deduction purposes despite the fact that the surviving spouse has only a life interest.[46] To the extent that marital deduction is claimed with respect to such annuity there would be no estate tax attributable by reason of the inclusion of such annuity in the estate of the primary annuitant, and therefore there would be no special deduction permitted under 1954 IRC § 691(d). The availability of this special deduction may prompt estate planners to advise the specific exclusion of such joint and survivor annuity from the property used to make up the marital deduction.[46a] This would be clearly desirable in any event where the amount of qualified property left to the surviving spouse is in excess of the maximum marital deduction.

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[45] 1954 IRC § 2056.

11. Payments from Sales on the Installment Plan

Under 1939 IRC § 44, permission was accorded under stated conditions to report income from sales on the installment plan on the proportion of the installment payments received in the taxable year which the gross profit realized or to be realized, when payment was completed, bore to the total contract price. Under 1939 IRC § 44(d) provision was made for gain or loss upon disposition of an installment obligation which included transmission by death. Specific provision was made that this subdivision should not apply to the transmission on death of installment obligations if appropriate filing was made with the Commissioner and an acceptable bond was given "conditioned upon the return as income, by the person receiving any payment on such obligations, of the same proportion of such payment as would be returnable as income by the decedent if he had lived and had received such payment." If such a bond was not filed, immediately on death gain or loss would be determined on the entire installment sale transaction and reported in the decedent's final return.[47] If the appropriate bond were filed and other requirements of the Commissioner were met, the installment payments were taxable in the same manner as if the decedent had survived to receive them. Under this latter procedure, the method of taxation provided did not come under prior Section 126(a). Consequently no deduction under prior Section 126(c) was allowable.[48]

The 1954 Code eliminated the inclusion in the decedent's final return of installment obligations, without requirement of any bond. The transmission of installment obligations on death is now specifically covered by 1954 IRC § 691(a)(4). An amount equal to the excess of the face value of the obligation over the cost basis to the decedent will be considered income in respect of a decedent and taxable when realized by the estate or beneficiary. In view of the taxability of this income under Section 691(a), the deduction for estate tax paid is available under Section 691(c).

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[46] 1954 IRC § 2056(b).

[46a] See *T. A. Desmond*, P-H 1954 T.C. Mem. Dec. par. 54265.

[47] See *Estate of Meyer Goldberg*, 189 F. (2d) 634 (2 Cir. 1951), where a deceased partner's final return failed to report the firm's unrealized installment profits and no bond was filed. The installment profits were held taxable in decedent's final return.

[48] But cf. *D. T. Austin* v. *U.S.*, 1954 P.H. Fed. Tax Serv. par. 72,378 (S.D. Tex. 1953) which allowed a 126(c) deduction for installment payments which were bonded and declared as received after decedent's death.

12. Legal, Accounting, and Other Professional Fees

Where professional work has been completed prior to a decedent professional's death, the fee when collected by his estate is clearly taxable under prior Section 126 and new Section 691. If professional work has not been completed up to the date of death and work remains to be done to complete such work, the amount ultimately paid to decedent's estate or beneficiary upon completion of the work, representing the value of the services to the date of death, is also clearly taxable to the estate or beneficiary when received.[49]

13. Sale of Crops and Livestock of Cash-Basis Farmer Decedent

The application of prior Section 126 to livestock and crops owned by a cash-basis farmer decedent was not entirely clear. With reference to the period prior to the enactment of prior Section 126, the Tax Court had held that the income represented by the value of unsold livestock and crops (harvested or standing) owned by the decedent at the time of his death was not accruable in the decedent farmer's final return under 1939 IRC § 42.[50] The Treasury Department has ruled that where one makes a gift of an unharvested crop, the income upon sale of the crop will be taxable to the grantor.[51] This constitutes an interpretation that the right to income from the crop has advanced to the point where the gift cannot sever the grantor's connection with the income. On this basis, it is likely that unharvested crops of a decedent farmer would be held to be income in respect of a decedent under prior Section 126 and new Section 691.[52]

14. Stock Options—Restricted and Unrestricted

Under the 1939 Code where a deceased executive had received an option at 85-95 per cent of market value, the amount received on surrender of this option by his executors has been held to be income in respect of a decedent under prior § 126.[53] Similarly, if the option is exercised by the executors and the stock subsequently sold, income is realized to the extent of the difference between the amount received and the option price. In both cases of surrender, or exercise with subsequent disposition, the estate or beneficiary was entitled to the § 126(c) deduction to the extent of the estate tax paid on the value of the option.

Where the restricted stock option was for 95 per cent of market value, upon surrender, or exercise with subsequent disposition, only capital gain is realized to the extent of the difference between the amount received and the option price.

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[49] See *Helvering* v. *Enright*, 312 U.S. 636 (1941) 25 AFTR 1213.

[50] Estate of *Tom L. Burnett*, 2 T.C. 897, appeal dismissed, 1944 Prentice-Hall Federal Tax Service, par. 62,642 (5 Cir. 1944), acquiesced in by the Commissioner on this point, 1944 C.B. 4.

[51] I.T. 3910, Cum. Bull. 1948-1, p. 15.

[52] See Robert B. Throckmorton, "Federal Taxation of the Farmer," Iowa Law Review, January 1949, Vol. 34 page 251.

[53] Cum. Bull. 1953-2, p. 178.

There is some question whether the § 126(c) deduction would be allowed against this income.

Under the 1939 Code the surrender by the executors or the sale of the stock after exercise of an unrestricted stock option results in ordinary income if the option is intended as compensation, and the § 126(c) deduction would be available. Where the option was not intended as compensation there is some question whether the § 126(c) deduction would be allowed.

The 1954 Code specifically provides that the tax benefits to an employee if he had exercised a restricted stock option are also available to his estate or beneficiary upon exercise of the option. The estate or beneficiary, however, is free of the following restrictions:

1. Neither the beneficiary nor the estate must be an employee when the option is exercised.
2. The estate or beneficiary can dispose of the stock at any time, free of the two year holding period requirement from the date the option was granted and the six month period from the date the stock was acquired.

Under the 1954 Code where the estate has exercised an 85-95 per cent option, and then distributes the stock to a beneficiary, such distribution probably does not constitute a disposition for purposes of § 421(6)(A)(ii). The sale of the stock by the beneficiary results in taxable income and the beneficiary would be entitled to the § 691(c) deduction. If the employee exercised the option during his lifetime, then the employee's death is treated as a disposition and the gain must be reported in the decedent's final return under § 421(b).

In the case of an option at 95 per cent of market value or over where the employee has exercised the option during his lifetime, the event of death does not constitute a disposition. The stock is included in the decedent's estate at its fair market value. § 1014(d) 1954 Code excepts from the stepped-up cost basis of property on death only restricted stock options not exercised at date of death. Upon sale of the stock by the executors there would be capital gains on the difference between the new cost, value for estate tax purposes, and the sales price. Since the application of § 691(c) is limited to income described under § 421(b), *i.e.*, compensation income, there would appear to be no § 691(c) deduction with respect to this income. Where the employee has not exercised the option in his lifetime, the value of the option is included in the decedent's estate but the cost basis of the stock when acquired is actual cost of exercise and upon disposition there is capital gain to the extent of the excess over this cost. But for the reason stated above there is no § 691(c) deduction.

Surrender of the option by the estate or beneficiary would be treated taxwise like a sale of the option. The gain would be the difference between the option price and the fair value of the stock on the date of surrender.

In the case of an unrestricted stock option, the tax treatment both under the 1939 and 1954 Codes turns on whether the option was intended as compensation to the employee. If the employee exercised the option, then gain would be realized at the date of exercise, whether ordinary or capital, dependent on whether the option was intended as compensation or not. If the estate or beneficiary exercised the option then on exercise, there would be gain on exercise to the extent of the difference between the option price and the value of the stock on the date of exercise. The estate or beneficiary would be entitled to the § 691(c) deduction.

On the basis of the foregoing it would appear to be an advantage for the employee to exercise a 95 per cent, and over, restricted stock option since exercise by the estate loses the stepped-up cost basis, and the higher capital gain is not reduced by the § 691(c) deduction. Furthermore the need to sell the stock by the estate before the stock has been held for six months may result in the penalty of short term capital gain. On the other hand, it may be an advantage for the estate to exercise an 85-95 per cent restricted option or an unrestricted option because of the availability of the § 691(c) deduction coupled with other factors.

15. Transfers of Income Items Transmitted by Death

In order to prevent any avoidance of the tax on income items transmitted by death, both the 1939 Code and 1954 Code provide that where such items are transferred by the estate or the person entitled thereto, the estate or such person must include in its or his gross income for the taxable period in which the transfer occurs, the fair market value of such item plus any amount received in excess of such value.[54] In other words, the law treats a transfer of the income item as the equivalent of its collection. This works out fairly in the ordinary case, but there are instances where the insistence upon full realization at the moment of transfer may work out to the serious disadvantage of the taxpayer. If an income item consists of a series of notes payable over a period of five years in equal amounts and, at the debtor's request, these notes are exchanged for other notes covering a longer period of time, such exchange would result in a realization of income to the extent of the full amount of the notes appropriately discounted to the date of exchange. The income would thus be subjected to tax in the year of exchange. This adverse result could be avoided by extending the notes instead of exchanging the notes.

The disposition of a decedent's interest in a business may bring about serious additional taxes by reason of these rules. Thus, if the executors of a decedent who was formerly a partner in a personal service partnership should agree to accept payments for a period of time in exchange for the decedent partner's rights in work in process and receivables, the estate may be taxed on the entire amount of such agreed payments in the year when the agreement is reached even though the agreement might provide that the payments should be extended over a period of years. This may be avoided by having the payments made against an agreed valuation of decedent's interest with express provision that decedent's interest in any items collected would be released and assigned to the survivors only as and when payments in the amount of his interest were received.

Under prior Section 126 both a gift of an income item as well as a bequest of such item were treated as the equivalent of a transfer. A devolution by death of a Section 126 item should not have been considered a transfer under Section 126(a)(2) but should simply have constituted income in respect of the second decedent. Certainly where there was no will and an income item of this kind passed by intestacy, there would have been no volitional transfer. It would have seemed that no different treatment should have been accorded a bequest of a Section 126 item.[55]

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[54] 1939 IRC § 126(a)(2), 1954 IRC § 691(a)(2).

The 1954 Code has remedied this inequity and has made applicable the provisions of Section 691 to both the first decedent and any subsequent decedent who becomes entitled to the income item through bequest or inheritance. The Section 691(c) deduction would be allowed for the estate tax paid thereon in each estate through which the income item passes.

16. Income Tax Deduction for Estate Tax Paid on Income Items Transmitted by a Decedent

1939 IRC § 126(c) and 1954 IRC § 691(c) allow an income tax deduction to the person who includes the income item in his return to the extent that such item has added to the estate tax payable by decedent's estate. The deduction is allowed to the person entitled to the income item, even though such person may not have paid any part of the estate tax attributable to such item.

Not only is the deduction available to the person who collects the income item but also to the person who, by reason of a transfer or sale of the item as discussed above, becomes taxable thereon. The year when the income item is includible is the year for which the deduction is allowed. Because of possible delays in the completion of the estate tax proceedings, the income item might be collected before the final amount of the deduction has been determined. Since the approximate total net estate and the probable highest estate tax bracket of a decedent may be determinable, in order to avoid filing refund claims it would be desirable to compute such deduction on the basis of such an estimate.

The amount of the deduction, which depends upon the amount of estate tax added by the inclusion of the income item, may not always be computable by using the face amount of the income item. The income item may be payable at some later date, and therefore the value of the item subjected to estate tax may be less than the face amount by reason of appropriate discounting.

The question of who was entitled to take the deduction under Section 126(c) was somewhat complicated where before or after the collection of the income item, the executor of the estate or a trustee to whom the income item may have been transferred pursuant to directions in a will, distributed the income item to a beneficiary. If the income item had not yet been collected, the transfer to a beneficiary under the terms of the will of the right to the income item was a transfer by bequest, devise or inheritance with the result that the executor or trustee did not realize income on such transfer[56] and the beneficiary realized the income upon collection of the item. Where, however, the executor or trustee collected and then distributed the proceeds of the item, did the item continue taxable to the executor or trustee or was it taxable to the beneficiary? 1939 IRC § 126(a)(1)(A) literally provides that the estate or trust becomes taxable on collection of the item.

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[55] See Abraham S. Guterman, "Income of Decedents—New Problems in Income and Estate Taxes under § 126," *Proceedings of New York University Fourth Annual Institute on Federal Taxation*, pages 25, 41. New York: Matthew Bender and Company, 1946. This view is supported by Informal Ruling 1952 CCH Fed. Tax. Serv., par. 6221.

[56] 1939 IRC § 126(a)(2).

The courts have taken the position that the executor or trustee who collects the income item is taxable thereon under prior Section 126, and no distribution to a beneficiary will be allowed to shift the incidence of the tax under 1939 IRC § 162.[57]

The 1954 Code makes the beneficiary of an estate or trust taxable on any item of income paid, credited or distributable during the estate's or trust's taxable year. The beneficiary is entitled to the deduction under 691(c) for estate tax paid on the income item in the proportion that the proceeds of such item were received by the beneficiary. This permits the 691(c) deduction to follow the inclusion of the income as between the estate or trust and the beneficiary.

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[57] *Ralph R. Huesman*, 16 T.C. 656 (1952), aff'd on other grounds 198 F. (2d) 133 (9th Cir. 1952); *Rose J. Linde*, 17 T.C. 584 (1952), aff'd 213 F. (2d) 1 (9th Cir. 1954); *Estate of Robert L. Clymer*, 13 T.C.M. 715 (1954).

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Tax Problems Peculiar to Professional Persons

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The principal tax problem of professional people arises because of "bunched income." After many years of preparatory work and low income, the professional —actor, attorney, author, or inventor—having gained recognition, may receive in a period of a few years, or even in one year, a substantial portion of the total earnings of his entire career.

1. Points to Consider

Section

How to spread bunched income over past years 3
  How to treat compensation for personal services . . . . (a)
  How to treat income from artistic work . . . . (b)
  How to treat income from invention or patent . . . . (c)
  How to treat income from patent infringement . . . . (d)
How to spread it over future years 4
How to take advantage of low capital gains tax 5
How to assign an interest to member of family 6

Some of these methods for minimizing the tax on "bunched income" are found in special provisions of the law enacted expressly for that purpose. Others are based upon the general provisions of the law, rulings, and decisions.

2. Other Points to Consider

Section

How to use corporations 7
How to treat foreign income of U.S. residents 8
How to treat U.S. income of aliens 9
How to treat paid charitable performances 10
How to deduct professional expenses 11

3. How to Spread Bunched Income over Past Years[1]

This method for minimizing tax can apply to: (a) compensation for personal service (1954 IRC § 1301; 1939 IRC § 107(a); (b) income from artistic work

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[1] As originally enacted in 1939, Section 107 of the 1939 Code applied only to compensation for personal services. Par. (b), dealing with income from artistic work, and the like, was

(1954 IRC § 1302; 1939 IRC § 107(b)); and (c) income from an invention (1954 IRC § 1302; 1939 IRC § 107(b)).

The relief provided by Sections 1301 and 1302 is not applicable to all compensation or income from artistic works or inventions. The Section is considerably restricted in its scope. Nevertheless, in those instances where it does come into play, the saving can be substantial. To obtain the relief, two tests must be met: (1) time test, (2) income test.

The tax saving under Sections 1301 and 1302 works as follows: (a) compute the increase in tax for the year the bunched income was received, (b) then compute the taxes that would have been payable if the income had been received in the past years to which it is allocated under the Sections. If the amount computed under (b) is less than that computed under (a), the difference represents the amount of the saving.

a. How to treat compensation for personal services. Section 1301 applies to compensation for personal services earned by any *individual or partnership* if 36 calendar months[2] or more elapse from the beginning to completion of the employment; and 80 per cent or more of the total compensation was received or accrued in one taxable year.

This provision is of special interest to attorneys and, to a lesser degree, to members of other professions, such as engineers, doctors, and others. It also may apply to executors and trustees and, under certain conditions, to business executives.

Only income that constitutes compensation for personal services is within the scope of Section 1301. The form in which payment is received is immaterial. It may be cash or property. If the payment is received in stock, the statute applies to the value of the stock but not to the dividends thereafter received upon the stock.[3]

It is not a prerequisite that the payment be received upon the completion of the services.[4] It may be received during the course of the work or after completion. However, if the compensation is collected in a year prior to completion of the services, the relief may be substantially limited as discussed below under "How to compute tax saving."

For the purposes of Section 1301, an employer-employee relationship is not required. Compensation received by an independent contractor can qualify. There should be a deal, arrangement, or understanding relating to the work or services to be performed. In fact, some arrangement is almost always necessary to establish the period covered by the services in order to meet the 36-month time test discussed below.

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added to the 1939 Code by Section 139 of the Revenue Act of 1942, and was made retroactive to taxable years beginning after December 31, 1940. Section 1301 of the 1954 Code applies to compensation for personal services and Section 1302 to income from artistic works and inventions; both Sections, with certain exceptions noted in the text, apply to years beginning after December 31, 1953 and ending after August 16, 1954.

[2] For taxable years beginning after December 31, 1940 and before January 1, 1942, the time test was 60 calendar months. Section 139(b) of Revenue Act of 1942. In computing the time requirement, Section 1304(a) provides that a fractional part of a month is disregarded unless it amounts to more than half a month, in which case it is considered a month.

[3] *Steckel* v. *Commissioner* (6 Cir. 1946), 154 F. 2d 4, 34 AFTR 1078.

[4] See discussions of amendments by Revenue Act of 1942 at Section 8.11 of Jacob Mertens' *Law of Federal Income Taxation.* Chicago: Callaghan and Company, Inc., 1942.

The 1954 Code introduced the term "an employment." The underlying idea of this term is that the compensation must relate to a particular project, such as a particular law case, and not to a set of unrelated services that the taxpayer may have performed for the same person.

Because of the 80 per cent income test, regular employees cannot qualify for relief as readily as independent contractors, for they must prove that the lump sum payment is wholly separate and apart from their ordinary compensation.[5]

A partner may obtain the benefit of Section 1301 even though he took no part in the services performed.[6] Under the 1939 Code, a new partner, sharing in a fee received by the partnership for services rendered prior to his admission, was entitled to use Section 107.[7] This was true even if he was not a partner for 36 months at the time the fee was received.[8] Under the 1954 Code a partner may qualify for relief under Section 1301 only if he has been a member of the partnership for 36 months or for the period of employment of the partnership preceding the receipt or accrual of the income.

Fiduciary commissions are in the scope of Section 1301.[9] However, all commissions, income and corpus, must be aggregated. Thus, if a trustee annually receives his commission for distributing and receiving income, and receives the commissions on principal in a lump sum, the relief provision would apply to the principal commissions only if they are 80 per cent or more of the total commissions.[10] Commissions received upon an intermediate account cannot be treated separately.[11]

Compensation payable after death and reportable by the executor or other recipient in accordance with Sec. 691, is entitled to the benefits of Sec. 1301 if the statutory requirements are otherwise met.[11a]

Time test. The services must cover a period of at least 36 calendar months. It is not necessary that a taxpayer work on the particular job continuously during the statutory period, provided that the time from the beginning of the work to its completion covered a period of at least 36 months. The time test is met even though there were certain intervals of inactivity during the 36-month period.

Time spent in general preparatory work prior to some arrangement or deal does not form part of the 36-month statutory period. This does not mean that the commencement of the 36-month period is deferred until the specific terms of the deal have been definitely settled, but generally there must be an invitation from the other party to the taxpayer to undertake the work.[12] Prior to such invitation, the taxpayer may have devoted some time to preliminary conferences and to a study of the facts and records of the particular matter. Such time should be taken into account if the conferences and study were specifically requested by the prospective client.

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[5] *L. C. Walsh,* Prentice-Hall Memorandum T.C., February 4, 1946 (bonus received for twenty-five years of service not within Section 107); *Paul J. Toner,* Prentice-Hall Memorandum T.C., December 31, 1943 (stock received by sales manager upon organization of new company); *Bertha Kirkpatrick,* Prentice-Hall Memorandum T.C., December 15, 1944 (bookkeeper entitled to Section 107 benefits on amount received for special services). See also footnote 16 below.

[6] Reg. 118, § 39.107-1.

[7] *Elder W. Marshall,* 14 T.C. 90; *Burnham Enerson,* T.C. Memo, Jan. 26, 1950, par. 50,024 Prentice-Hall Memorandum T.C.

[8] Footnote 7, above; *Sigvald Nielson,* T.C. Memo, January 26, 1950, par. 50,025 Prentice-Hall Memorandum T.C.; the Commissioner was in accord with this view, G.C.M. 26993, 1951-2 C.B. 54, revoking G.C.M. 25795, 1948-2 C.B. 61.

[9] *Estate of Edward W. Clark,* 2 T.C. 676 (1943).

[10] *Harry Civiletti,* 3 T.C. 1274 (1944), affirmed (2 Cir. 1945) 152 F. 2d 332, 34 AFTR 590; *Paul H. Smart,* 4 T.C. 846 (1945), affirmed (2 Cir. 1945) 152 F. 2d 333, 34 AFTR 591.

[11] *Ralph E. Lum,* 12 T.C. 375 (1949).

[11a] Reg. 118, § 39.126(a)-1(g).

A modification of the terms of the compensation arrangement during the course of the work will not break the continuity of the 36-month period. Thus, if an attorney, having spent 24 months on a certain case, makes a new fee arrangement with his client, the prior two years may be counted as part of the statutory period.[13]

Income test. Eighty per cent or more of the compensation for the particular job must be received or accrued in one taxable year.[14] Hence, if an individual who prepares his returns on the cash basis undertakes certain work on March 17, 1951, completes it on September 1, 1954, and is paid $10,000 for his services on the completion date, he will be entitled to the benefits of Section 1301 provided the $10,000 is at least 80 per cent of total compensation paid or to be paid for such work. However, if he were to receive an additional $5,000 for such work in 1955, he would not be entitled to the benefits of Section 1301 with respect to either the $10,000 or the $5,000, because under these circumstances he would not have received in one year at least 80 per cent of the total compensation for the job.[15]

If the taxpayer worked on only one particular job for the payor of the compensation, it is a simple matter to determine whether the 80 per cent test is met. However, such determination becomes more difficult if he worked on two or more different matters for the same person at the same time.[16]

How to compute tax saving and how to secure it. If the time and income tests above are met, the tax payable upon the bunched compensation is limited to the amount that would have been payable if it had been received ratably over the period of the services preceding the date of receipt.[17] Thus, if an attorney, upon the settlement of a matter on July 1, 1955, received $48,000, and he commenced the work on July 1, 1951 (a period of 48 months), he would be entitled to compute his tax for 1955 on the $48,000, as if he had received $1,000 per month beginning with July 1, 1951 and ending with July 1, 1955. It is doubtful that the period for spreading the income could be extended to December 31, 1955, but see the discussion at footnote 17.

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[12] *Guy C. Myers,* 11 T.C. 447 (1948); *Jean de Marco,* 9 T.C. 1188 (1948). (Work performed by sculptor prior to announcement of competition not included in time test).

[13] *Frederico Stallforth,* 6 T.C. 140 (1946).

[14] 1954 IRC § 1301(a)(3); Reg. 118, § 39.107-1.

[15] *Julia C. Nast,* 7 T.C. 432 (1946). (Doctor accumulating certain charges not entitled to apply Section 107, since payments on account had to be included in applying the 80 per cent test.)

[16] Executive working for two corporations under separate contracts, entitled to apply Section 107 to a bonus received from one corporation, such bonus being his only compensation from that corporation. *Estate of Nina Huddleson,* T.C. Memo, February 11, 1949, par. 49,032 Prentice-Hall Memorandum T.C. Additional payment received by executive for effecting the unification of various businesses held separate from his regular compensation within Section 107. D.G. Slee, T.C. Memo, July 8, 1943, par. 43,331 Prentice-Hall Memorandum T.C. Construction engineer working on separate projects under one agreement with his employer, not entitled to benefits of Section 107. *J. Mackay Spears,* 7 T.C. 1271 (1946). Supervisor of insurance agents not allowed to use Section 107 on commissions on policies that he sold. *Harry Boverman,* 10 T.C. 476 (1948). See also footnote 5, above.

[17] Reg. 118, § 39.107-1. "Under the rule stated in the regulation, it would appear that compensation received in a taxable year commencing after the close of the year in which the services were completed should be allocated to the prior years when the services were rendered and no part should be allocated to the year of receipt. The Supreme Court, however, has ruled that income from an artistic work or invention under Section 107(b) as opposed to compensation for services, must be spread over the 36 months period ending with the close of the year of receipt although the work period ended many years prior thereto." *Leroy J. Robertson* v. *U.S.,* 343 U.S. 711, 41 AFTR 1053 (1952). See footnote 29, below, and the text to which this footnote relates.

Under the 1939 Code it was held that where an attorney received Section 107 compensation in a year in which he and his wife filed a joint return, one-half of the compensation was to be allocated to each spouse before prorating the compensation over the years in which it was earned.[18] This rule, where husband and wife filed separate returns in the years to which the income was to be allocated, made possible further reduction in surtaxes by allocating one-half of the compensation to the separate returns of each spouse rather than adding the entire compensation to the income of the husband during the years of allocation.

The 1954 Code has changed the rule as to compensation received after March 1, 1954. Section 1301 income received is considered income only of the person who would be required to include it in a separate return for the year in which it was received.[19] For example, if an architect receives in 1955 a fee upon completion of an employment begun in 1946 and he and his wife file a joint return for 1955 but filed separate returns for 1946 and 1947, no part of the fee allocable to 1946 and 1947 services is considered income of the architect's wife in those years.

In computing the tax for the years to which the income is attributable, to determine the allowable amount of charitable contributions deduction and medical expense deduction, there must be a recomputation of these deductions for each increase in gross income under Section 1301.[20]

If the tax computed under Section 1301 is smaller than the tax that would be payable if the compensation were included in full in the year received, the smaller amount is paid with the return. It is not necessary to pay the larger tax computed in the regular way and then file a claim for refund. In other words, the saving is reflected in the original return as filed. Of course, there may be situations in which a taxpayer, at the end of a particular year, cannot be certain that the compensation received during the year amounts to 80 per cent of the total compensation for the job. At a later time, when it is determined that the amount received in the prior year met the 80 per cent test, it would be necessary for the taxpayer to file a claim for refund in order to obtain the relief.

Generally, because of the graduated surtax rates, the longer the period over which the income is allocated for the tax computation under Section 1301, the smaller the tax. It may be more advisable, therefore, for the taxpayer to receive the bunched compensation after the completion of the services than during the course of the work. In the example above, the taxpayer was allowed to allocate the $48,000 over 48 months. If he had received the payment on July 1, 1954, the allocation would have been limited to 36 months, even though his services continued for 12 months after the receipt of the fee.

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[18] *Marshall* v. *Hefferbert* (D.C., D.Md. 1952), 108 F. Supp. 350, 42 AFTR 1049; aff'd (4 Cir. 1952) 200 F 2d 648, 42 AFTR 1014.

[19] 1954 IRC § 1305(c).

[20] I.R. Mim. No. 43, Sept. 30, 1952; *Edward C. Thayer*, 12 T.C. 795.

In the computation of the tax relief, the tax on self-employment income is not affected.[20a]

It should be stressed that Section 1301 is elective and, therefore, will be used only if it results in a tax that is lower than the amount that would result if the full amount of compensation were taxed in the year in which received.

b. How to treat income from artistic works. "Artistic work" is defined as a literary, musical, or artistic composition or a copyright covering a literary, musical, or artistic composition.[21] Although most of such works are of necessity copyrighted, a copyright is not a prerequisite to the application of Section 1302.

By its express terms, Section 1302 applies only to individuals. Thus, it would apparently not be available to a partnership, trust, corporation or association.

Time test. The time test relates to the period from the beginning to the completion of the artistic work. This period must be at least 24 months.[22] However, the author or artist need not devote all of his time during the 24 month period to a particular work. The only requirement is that he devote some part of his time over the period of 24 months or more. For example, if the writing of a novel covers the statutory period of at least 24 months, the income realized from such work may come within the scope of the statute, even though the author may have written another novel or one or more short stories during the same period of time.

The time factor is, of course, often within the control of the author or artist. Truly, this is one situation in which haste can make waste. If Author A applies himself diligently and completes his novel in one or one and a half years, he will not be entitled to any tax relief. Author B, on the other hand, who purposely defers the completion of his work until the 24 months have elapsed, may be entitled to relief. Thus, even if the gross royalties of A and B are the same, B's net income after taxes may be substantially greater than that of A.

A difficult problem may arise in some cases in the determination of the date of the beginning of the work and the date of its completion.[23] Neither the law nor the regulations throw any light on this problem. The terminal date is not necessarily the date of the issuance of the copyright, but some prior date, since the statute refers to the completion of the literary work and not to the date it was copyrighted. It is an open question whether the time spent by the editorial department of a publishing company upon the manuscript of an author following its submission is included in determining the time test. Since the law refers to the time spent on the work by the individual taxpayer, it is doubtful whether the editorial period can be taken into consideration. The determination of the date of the beginning of the work also presents some questions. The Tax Court has held that a particular work was begun when an author started to make notes later to be incorporated in a manuscript.[24] That court has also indicated that research time preliminary to actual preparation of the manuscript should be included in the period of work although little writing or typing is done during the period.[25]

[20a] 1954 IRC § 1305(b).

[21] 1954 IRC § 1302(b)(2).

[22] Under the 1939 Code the time test was 36 months. 1939 IRC § 107(b).

[23] Authors should preserve all records and data indicating that the statutory time requirement has been met. For example: keep a diary, date original notes, retain receipts for travel expenses in connection with preliminary research, save hotel bills, ticket stubs, and similar records.

[24] *Cliff David Richardson*, 14 T.C. 547 (1950).

Income test. In general, the income test requires that the income from a particular work be received by the author or artist largely in one taxable year. To be specific, in the taxable year in which Section 1302 is applied, the gross income from the particular artistic work must be not less than 80 per cent of the sum of the following: (a) the gross income from the work in the taxable year; and (b) the gross income from the work in previous taxable years and in the 12 months following the close of the taxable year.[26]

To illustrate this rule, assume that the work was commenced in 1946, completed late in 1953, and that the author or artist received $2,000 in royalties in 1953, $45,000 in 1954, and $3,000 in 1955. Under these facts, the taxpayer is eligible for relief under Section 1302 with respect to the year 1954, since his royalties for 1954 ($45,000) are 80 per cent or more—in fact, they are 90 per cent—of the sum of the royalties received by him in 1953, 1954, and 1955 ($50,000).

The income test involves only the income received in the taxable year, in previous years, and in the first succeeding year. For instance, in the example cited above, the taxpayer would be eligible for relief for 1954 irrespective of the amounts of any income he might derive from the work in 1956 or subsequent years. Thus, even if he were to receive an additional $100,000 in 1956 or later on the disposition of the motion picture rights to the work, the receipt of such income would not deprive him of the benefits of Section 1302 for the year 1954.

Although, as just pointed out, the income received from the work in the second succeeding year, and later years, has no bearing on the problem, it is necessary to take into account all of the gross income realized from the work during the statutory period referred to. That is to say, previous years, the taxable year, and the first succeeding taxable year. Consider a book, for example. All of the income derived from it during the statutory period must be taken into account: income from book rights, serial rights, radio rights, motion picture rights, and others. Thus, if the 80 per cent test is met when only the income from book rights is considered, and not when the income from all other rights is taken into account, Section 1302 is not applicable.

Proration of expenses. Although the statute is silent as to the treatment of expenses of an author or inventor, the Service apparently takes the view that the expenses are to be prorated in the same manner as the income, provided that the expenses are directly related to the income. For example, the Service has held that commissions paid to an agent and fees paid to a rewrite assistant, where both items were determined by a percentage of the royalties received, should be treated as if paid ratably over the same period to which the royalties are allocated.[27] Of course, the only expenses that can be allocated are those paid in the taxable year in which Section 1302 is applied.

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[25] *Edwin Harvey Blum*, Par. 52,186 P-H Memo T.C. In this case the only written indication of the date of commencement of the work was a note written by the taxpayer concerning one character in his work, and the court strongly indicated that the mental labor of planning and study of background material was more essential to the preparation of a literary work than the physical effort of writing or typing.

[26] 1954 IRC § 1302(a)(3); Reg. 118, Section 29.107-2.

[27] I.T. 3773, 1945 C.B. 151.

How to compute tax saving. To illustrate the operation of the tax computation required under Section 1302, the example set forth above will be used. The work was begun on January 1, 1946 and completed on September 30, 1953. It was published in November, 1953 and the following royalties were received: $2,000 in 1953, $45,000 in 1954, and $3,000 in 1955.

Section 1302 is clearly applicable to the year 1954. Although the literary composition was begun in 1946 and completed in 1953, the $45,000 is not allocable over that period. Although the period of work in this case is six years and nine months and all of it preceded the close of 1954, Section 1302 limits the allocation period to a maximum of 36 months. Bearing this limitation in mind, should the $45,000 be allocated over the 36 month period ending September 30, 1953, the date of completion of the work, or the 36 month period ending December 31, 1954, the close of the taxable year? It was formerly believed that the correct period ended with the completion of the work,[28] in this case September 30, 1953, but the United States Supreme Court has held that the proper period ends with the close of the taxable year, or in other words with the last day of the year in which the Section 1302 income is received.[29] Thus, $45,000 is spread ratably over the three year period ending with December 31, 1954, and the tax payable on the $45,000 in 1954 is limited to the taxes that would have been payable thereon if the $45,000 had been received ratably over the 36 months from January 1, 1952 to December 31, 1954.

How to obtain tax saving. Where the taxpayer receives full payment for his work in one taxable year (or where he is reasonably certain that any payment he might receive in subsequent years will not preclude the application of Section 1302 to the taxable year), the tax saving is reflected in the return when it is originally filed. The tax payable in such return is the amount of tax that would have been payable if the payment had been received ratably over the statutory period. Accordingly, if the artistic work was undertaken on January 1, 1953 and completed on December 16, 1955, and the taxpayer receives $36,000 on December 20, 1955 in full payment, the tax payable in the 1955 return will be the amount that would have been paid if $12,000 had been received in each of the years 1953, 1954 and 1955.

However, in the ordinary case where royalties are received, the saving can generally be obtained only through a claim for refund because it will not be known until the close of the succeeding year whether the 80 per cent income test is met for a particular year.

c. How to treat income from an invention or patent. The principles applicable to income from inventions and patents are similar to those outlined above under "Income from artistic works." Twenty-four months or more must have elapsed from the beginning to the completion of the invention, and the income in the taxable year from the particular invention must be at least 80 per cent of the sum of the following: (1) income therefrom in the taxable year, (2) income therefrom in the previous years, and (3) income therefrom in the 12 months following the close of the taxable year.

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[28] *Williams* v. *U.S.*, (Ct. Cls. 1949) 84 F. Supp. 362, 37 AFTR 1563.

[29] *Leroy J. Robertson* v. *U.S.*, 343 U.S. 711, 41 AFTR 1053 (1952). In this case the Supreme Court made no mention of the *Williams* case at footnote 28, above. See also footnote 17, above.

However, income from an invention, as opposed to an artistic work, is given preferential treatment in an important respect. The maximum period for spreading income is extended to 60 months as opposed to 36 months for an artistic work.[30] "Invention" is defined in the 1954 Code as "a patent covering an invention of an individual."

Any income, other than capital gains, derived from an invention may be within the scope of Section 1302. Thus, both ordinary royalties and infringement awards or settlements could qualify for relief.[31] The income must, however, be derived from the invention. Thus income realized by an inventor from the manufacture and sale of articles covered by his patent is not eligible for Section 1302 relief. Only such portion of the income as can be shown to be allocable to the patent is eligible.[32]

Under the ordinary royalty agreement, it would be difficult for an inventor to meet the 80 per cent income test. However, this may be overcome in some cases through an arrangement providing for substantial advance royalties.

d. How to treat income from patent infringement suit. Under Section 1304 compensatory damages received under an award in a civil action for infringement of a U.S. patent may be spread over the months during which the infringement occurred if such spreading results in a lower tax. No statutory limitation is imposed upon the period over which the award may be allocated. The spread back is limited to that portion of the award representing compensatory damages and does not include increased damages over and above the amount found adequate to compensate for the infringement. It also does not include amounts awarded to the taxpayer as attorney's fees, interest, or costs.[32a]

4. How to Spread Income over Future Years

Deferring royalty payments of authors and inventors. Surtaxes on royalty income of authors and inventors may be reduced by spreading the income over future years by means of a deferred payment royalty plan. Spreading of the income is made possible primarily as a result of the fact that the amount of royalty income that may be realized is uncertain and is contingent upon circumstances that cannot be foretold with certainty.[33]

Generally 80 per cent or more of the royalties on a work of fiction are earned within a year or two of publication. Rather than permit royalty income to bunch in one or two years, an author can, by contract with his publisher, defer the receipt of royalties in such manner as to spread the income over a reasonably extended future period. For example, if it is estimated that an author will realize $75,000 in royalties from a work, he may enter into a contract with his publisher that provides that the publisher will limit royalty payments to $15,000 each year, regardless of the fact that a greater amount of royalties may have accrued, until such time as the total accrued royalties have been paid. Hence, on the basis of an estimate of $75,000 in royalties, the income will be paid and taxed over a period of five years rather than two years.

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[30] 1954 IRC § 1302(a). Under the 1939 Code the maximum period of spread of income was limited to 36 months in the case of an invention as well as an artistic work.

[31] *Williams* v. *U.S.*, footnote 14, above; see also *Nicholas W. Mathey*, 10 T.C. 1099 (1948).

[32] *Alfred W. Barber*, 19 T.C. 600 (1952).

[32a] 1954 IRC § 1304 applies to taxable years ending after the date of its enactment (August 11, 1955) but only with respect to amounts received or accrued after such date.

[33] *Burnet* v. *Logan*, 283 U.S. 404 (1931), 9 AFTR 1453.

It would appear that if the author reports his income on a cash basis, he would not be taxed on more than the royalties he actually receives, $15,000 each year, because this amount represents the maximum he is entitled to receive in any one year, regardless of the fact that royalties substantially in excess of this amount may have accrued for his ultimate benefit.[34]

Inventors may similarly defer the receipt of royalties. Although royalties received by an inventor are by their nature generally not received within a short time after an invention is put to use, but are received over a period of years, tax savings may nevertheless be effected for the inventor by placing a ceiling on the amount of royalties he may receive in any one year. Years of excessive income may thus be avoided.

Installment sale of manuscript. Another method for spreading income realized from a manuscript is to make an installment sale under 1954 IRC § 453(b); 1939 IRC § 44(b). To come within these provisions, the sales price must be in excess of $1,000 and the initial payments received in the taxable period of the sale cannot exceed 30 per cent of the selling price. The author and the publisher enter into an agreement for the preparation and delivery of a manuscript at a future date. Upon delivery of the manuscript and the assignment of all rights of every kind to the composition, the first installment (less than 30% of the total price) is paid, the balance of the purchase price being payable over future years. The excess of the selling price over the tax basis of the composition represents the taxable profit which is reportable as the payments are received. The author reports as income the percentage of each installment that the total profit bears to the contract price. For example, if the total price is $50,000 payable in five equal annual installments and the total profit is $45,000, the author will report 90 per cent of each $10,000 installment as income. Caution should be exercised in the handling of advance payments to the author.[35]

Leasing motion picture rights. Ordinarily, the consideration for motion picture rights is paid to an author in a lump sum. Such lump sum payment, which is taxed as ordinary income under the present interpretation of the law, results in the application of high surtax rates. Income from motion picture rights may be brought within lower surtax brackets by a leasing arrangement, whereby motion picture rights are leased to a motion picture company for a term of years with an option to purchase exercisable at the termination of the lease.

Spreading capital gains income over future years. If a sale of a patent or invention meets the requirements set out in Section 5 below, the taxpayer may realize capital gain from the transaction. In addition to the tax advantages that are set forth in Section 5, in that a long-term capital gain is subject to an effective maximum tax of 25 per cent, the inventor may, by contract, spread the receipt of his capital gain over future years in such a manner as to reduce the effective tax upon this income below 25 per cent.

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[34] *Howard Veit,* 8 T.C. 809 (1947); *Kay Kimbell,* 41 B.T.A. 940 (1940); *George P. Douglas,* 1 B.T.A. 372; *Richards' Estate* v. *Commissioner,* (2 Cir. 1945) 150 F. 2d 837, 34 AFTR 102; *James F. Oates* 18 T.C. 570, affd (7 Cir. 1953) 207 F. 2d 711.

[35] Rev. Rul. 234, I.R.B. 1953-22.

Assume that a taxpayer realizes long-term capital gain from a sale and that the sales price is determined by a formula similar to that for determining royalties. A contract with the purchaser may provide that the seller is to receive no more than a fixed sum each year toward payment of the purchase price, regardless of the fact that a greater amount of purchase price may have accrued. For example, assuming that the estimated amount to be paid for the invention is $50,000, the contract may limit payments toward the purchase price to $10,000 a year, until such time as the entire purchase price of the work has been paid. Since the payments received are long-term capital gains, only 50 per cent of the amount received, or $5,000, will be includible in the inventor's income each year. If the taxpayer does not have substantial income from other sources, the total tax each year on the $5,000 will be less than the effective maximum capital gains tax of 25 per cent.

5. How to Take Advantage of Low Capital Gains Tax

Under certain circumstances income realized from inventions and by actors may be brought within the category of long-term capital gains subject to capital gains tax rates with an effective ceiling of 25 per cent, as opposed to a possible maximum tax rate of 91 per cent. Possibility of capital gains on copyrights (except as to a person who purchased a copyright as an investment) is very limited and in any event is completely denied as to the author.[36]

Capital asset. In order to bring income within the capital gains category, a taxpayer must sell or exchange a "capital asset." Generally speaking, a capital asset is defined as all property held by a taxpayer with certain specified exceptions.[37]

Under the 1954 Code any inventor, professional or amateur, is entitled to capital gains treatment if he sells all substantial rights to his patent and the purchaser is not one of the related persons described in Sec. 1235(d). For this purpose, related persons include a corporation controlled by an inventor and certain relatives of the inventor, but not brothers and sisters. He need not hold the patent or invention more than 6 months. A person who purchases an interest in the patent prior to the time the invention is reduced to practice is entitled to similar treatment.[38] This rule does not apply to the employer of the inventor or to certain relatives of the inventor.

Under Section 1235 it is immaterial whether the purchase price is paid in a lump sum or is measured by a percentage of the selling price of units manufactured under the patent.

Section 1235 does not affect the operation of the general capital gain provisions in those areas outside its scope. Thus the tax consequences of the sale of patents by individuals who fail to qualify as "holders" (as defined in the statute), or the sale by a corporation are governed by the general capital gain rules.[38a]

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[36] Prior to the enactment of the Revenue Act of 1950, it was possible for a literary work to qualify as a capital asset. However, for taxable years beginning after September 23, 1950, literary works and copyrights are treated as ordinary assets in most cases and the income from their sale must be reported as ordinary income. 1939 IRC §§ 117(a) and (j), as amended by the Revenue Act of 1950, Section 210; 1954 IRC § 1221.

[37] 1939 IRC § 117(a); 1954 IRC § 1221. See also footnote 36, above.

[38] 1954 IRC § 1235.

[38a] Senate Finance Committee Report on IRC of 1954, p. 441.

The 1939 Code contained no special provisions relating to capital gain treatment of inventions. Patents and inventions had to meet all the requirements of the capital gain provisions. There was no question that a patent was property. However, in order for such property to be considered a capital asset, it could not constitute "property held . . . primarily for sale to customers in the ordinary course of . . . trade or business." If the patent was held for such purpose, proceeds from a sale thereof was not capital gain.

The crux of the matter under the 1939 Code was whether the patent was held primarily for sale in the ordinary course of a trade or business. Was the owner of the property engaged in the business of inventing? The problem was a factual one, and its determination depended upon such factors as the number of patents owned or disposed of by the inventor, the time devoted to inventing, as distinguished from other professions or businesses, the proportion of the total income of a taxpayer derived from such property, and similar considerations.

A substantial number of cases involving this question have been decided. A clerk who spent several hours each week in his spare time working on devices, and who obtained four patents in a period of 20 years, one of which was sold, was held to have realized capital gain,[39] as was a corporation executive who sold patents that resulted from spare time experimenting,[40] and an employee who by the terms of his employment contract was required to assign all of his inventions to his employer, but was permitted to sell one patent for his own profit after being informed that his employer was no longer interested in it.[41] The Tax Court in one case extended the doctrine to a taxpayer who was concededly in the business of inventing but who licensed all of his patents except two, which he sold, and held that the taxpayer realized capital gain from the sale, since he ordinarily licensed his patents, and therefore had not held his patents primarily for sale to customers in the ordinary course of his trade or business.[42]

On the other hand, a taxpayer who was employed to direct certain experimental work for his employer and who obtained 12 patents covering inventions that had been perfected during his spare time over a period of 17 years, was held to have realized ordinary income on the sale of five of these patents.[43]

Sale. As to patents, it is the weight of authority that the transfer of the exclusive right to make, use and vend constitutes a sale.[44] If less than the three rights are assigned, the transaction will be considered a licensing arrangement, rather than a sale, and the proceeds will be considered royalties, not capital gain.[45] A sale can be made of the complete patent or an undivided interest therein.[46] To be more specific, the patentee may assign "either the whole patent, comprising the exclusive right to make, use and vend the invention throughout the United States; or (2) an undivided part or share of that exclusive right; or (3) the exclusive right under the patent within and throughout a specified part of the United States."[47] The fact that the parties are referred to in the contract as licensor and licensee is immaterial;[48] the controlling factor is that all three of the rights are transferred. Similarly, the revesting of title in the assignor upon a default in the payment of a minimum royalty or installment of the purchase price will not defeat a sale, provided the revesting or revocation conditions are conditions subsequent.[49]

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[39] *John W. Hogg*, T.C. Memo, March 1, 1944 par. 44,066 Prentice-Hall Memorandum T.C.

[40] *Lee Walker*, T.C. Memo, Oct. 11, 1945 par. 45,316 Prentice-Hall Memorandum T.C.

[41] *Maurice B. Cooke*, T.C. Memo, Feb. 9, 1945 par. 45,065 Prentice-Hall Memorandum T.C.

[42] *Lester P. Barlow*, T.C. Memo, May 19, 1943, par. 43,237 Prentice-Hall Memorandum T.C., see also *William M. Kelly*, T.C. Memo, June 12, 1947 par. 47,252 Prentice-Hall Memorandum T.C.

[43] *Harold T. Avery*, 47 B.T.A. 538 (1942); see also *Leo M. Harvey*, T.C. Memo, March 24, 1947, par. 47,069 Prentice-Hall Memorandum T.C.

[44] *Kimble Glass Co.*, 9 T.C. 183 (1947); *Edward C. Myers*, 6 T.C. 258 (1946); *Carruthers* v. *U.S.* (D.C., Ore. March 3, 1953). See also *Federal Laboratories, Inc.*, 8 T.C. 1150 (1947). But cf. *Bloch* v. *United States*, (2 Cir. 1952) 200 F. 2d 63, 42 AFTR 909, in which the Court of Appeals disapproved of the *Kimble Glass* and *Myers* cases and of decisions of the Fifth Circuit and the Court of Appeals of the District of Columbia to the same effect. In the *Bloch* case the court held that the grant of a license to make use and vend by a non-resident alien was not a sale of his patent and that the case of *Waterman* v. *Mackenzie* (footnote 47, below) is not applicable to tax cases. See also *Eterpen Financiera Sociedad* v. *United States* (Ct. Cls. 1952) 108 F. Supp. 100, 42 AFTR 831.

An assignment of a patent to an employer pursuant to an employment contract, under the terms of which any inventions of the employee were to be transferred to the employer without any additional compensation, is not a sale for tax purposes.[50]

A more difficult problem is faced by a professional actor whose show derives its value principally from his personal popularity and services. Ordinarily, a radio or television network purchasing a show from a well-known actor also enters into an employment contract with the actor under which he agrees to perform in the show at a specified salary. In such case, the tax authorities might take the position that the network is purchasing the continued employment of the actor and that the income realized is compensation for personal services. Thus, assuming a radio show is sold for $1,000,000, the tax authorities might take the position that actually $100,000 was paid for the show, and the remaining consideration was paid to the actor as compensation for services to be rendered.

The Treasury Department has announced that proposals of radio artists and others to obtain compensation for personal services under the guise of sales of property cannot be regarded as coming within the capital gains provisions.[50a]

An amount received for the assignment of a singer's booking agency contract, which permitted the assignee to make a new contract with the singer, was held to be ordinary income and not capital gain. The amounts received by the booking agency to a large extent represented commissions earned on contracts obtained for the singer and as such were held to be ordinary income.[50b]

Holding period. The effective ceiling of 25 per cent on the capital gain is applicable only to a long-term capital gain—one resulting from the sale or exchange of an asset that a taxpayer has owned for more than six months. With the one exception noted below, it is thus imperative that a taxpayer hold a capital asset for more than six months before making the sale.

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[45] *Kimble Glass Co.*, footnote 44, above; *Lynne Gregg*, 18 T.C. 291 (1952).

[46] *Parke, Davis & Co.*, 31 B.T.A. 427.

[47] *Waterman* v. *Mackenzie*, 138 U.S. 252.

[48] Footnote 46 above.

[49] Footnote 44, above, and *Commissioner* v. *Celanese Corp.* (D.C. Cir. 1944), 140 F. 2d 339, 32 AFTR 42.

[50] *Arthur N. Blum*, 11 T.C. 101 (1948).

[50a] Treas. Dept. Info. Ser. S-952, Jan. 3, 1949.

[50b] *General Artists Corporation*, 17 T.C. 1517, affd. (CA-2, 1953), 205 F. 2d 360, cert. den. 10-25-53.

Under the 1954 Code the sale of a patent by a "patent holder" results in long-term capital gains regardless of whether or not the invention or patent was held for more than 6 months.[51]

Under the 1939 Code the holding period of patents and inventions, as of all other capital assets, was required to exceed 6 months. The holding period of an invention begins on the date the invention was reduced to actual practice, and its feasibility and value demonstrated.[52] Such date, of course, may precede the date of the issuance of the patent or filing of the application. Accordingly, under the 1939 Code it was not always necessary to hold the patent for more than six months in order to realize a long-term capital gain.

6. How to Assign an Interest to a Member of a Family

Another possibility of avoiding the higher surtax rates on bunched income is by way of gifts of all or certain of the taxpayer's interests in a patent, copyright, theatrical show, or other income-producing property, to members of his family, who have little or no income of their own. Due to the income-splitting privilege allowed to husband and wife under the present law, such gift to a spouse would not reduce taxes. The donee should be a child of the taxpayer, or for that matter, anyone other than his wife.

To shift the tax burden to the donee or assignee, there must be an assignment of the property or property right that produces the income. A mere assignment of the right to the income will not suffice.[53] The tree, not merely the fruit that grows on the tree, must be the subject matter of the gift. Thus, a gift of a percentage of the royalties due under a contract will not relieve the taxpayer from tax, even though the assignees are legally entitled to a part of the payments.[54] The tax will be shifted, however, if the taxpayer assigns an undivided interest in the property—patent, copyright, license contract, and the like—that produces the royalties.[55]

Assignments of royalty contracts have been held to be assignments of property and, therefore, effective to shift the income. The usual case is where the assignor is the owner of the patent. However, where the assignor acquired the royalty interest for services rendered, and had no interest in or control over the invention, the assignment failed for tax purposes, since there was no transfer of property.[56] The safest method is to give an undivided interest in the patent, invention, or copyright itself.

An oral agreement has been held sufficient as an assignment for tax purposes.[57] Obviously, a written agreement is preferable, if for no other reason than the matter of proof.

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[51] 1954 IRC § 1235.

[52] *Samuel E. Diescher*, 36 B.T.A. 732 (1937); G.C.M. 21507, 1939-2 C.B. 189; *Wilma M. Imm*, par. 52,080 Prentice-Hall Memorandum T.C. (1952).

[53] *Helvering* v. *Horst*, 311 U.S. 112, 24 AFTR 1058 (1940); *Lucas* v. *Earl*, 281 U.S. 111, 8 AFTR 10287 (1930).

[54] *George J. Nicholson*, 3 T.C. 596 (1944); *Strauss* v. *Commissioner* (2 Cir. 1948), 168 F. 2d 441, 36 AFTR 1072; *Lewis* v. *Rothensies*, 61 F. Supp. 862, 34 AFTR 206.

[55] *Carl G. Dreymann*, 11 T.C. 153 (1948).

[56] *Strauss* v. *Commissioner* (2 Cir. 1948), 168 F. 2d 441, 36 AFTR 1072.

[57] See footnote 55.

Not only is it necessary to assign the property, rather than the income, but the gift must be complete. The donor must surrender all dominion and control over the property. For example, a taxpayer assigns to his children patent license contracts between himself and a corporation. He is the principal stockholder and officer. He retains a substantial interest in the contracts because of his right to cancel the contracts. Therefore, royalties will still be taxable to him. The control he retains over the flow of the income from the property makes him the true owner of the property for tax purposes.[58]

The gifts in question, if they are complete, with no strings attached, will constitute gifts for gift tax purposes. In order to minimize the gift tax, the assignment should be made before the subject matter has attained any substantial value. Thus, a gift of an undivided interest in an invention might be made during the course of the experimental or developmental period. Agreements to assign future inventions are valid and enforceable.[59] In the case of a literary work, the assignment could be made prior to its acceptance for publication or even prior to its completion. Under exceptional circumstances, a literary work might have a substantial value before arrangements are made for publication, particularly if the author has already written one or more best sellers. In any event, its value at such time should be considerably less than it will be after its success has been assured by a favorable reception on the part of the critics and the public.

7. How to Use Corporations

The use of a corporation may effectively reduce the tax of an actor, author, or inventor if a substantial portion of his income falls in high surtax brackets and he is willing to risk a portion of his assets in the operation of a real estate, manufacturing, merchandising, or similar business.

It should be stressed that the Treasury scrutinizes very carefully any attempts to minimize taxes by seeking refuge in the act of incorporation.[60] In working out any plan involving the use of a corporation, the important objectives are permanency and genuine business activity.

The difficulties encountered in this field are: the personal holding company provisions, the accumulated earnings tax, and the double taxation of corporate income (a tax to the corporation upon the receipt of the income and another tax to the stockholder if and when the income is distributed to him).

You have a personal holding company if (a) 50 per cent or more of the stock is owned by five or less individuals;[61] and (b) 80 per cent of the gross income is from certain specified sources including dividends, interest, securities gains, *royalties,*[62] and *certain compensation earned by stockholders.*[63] In addition to the regular corporate tax, such companies are subject to a surtax of 75 per cent to 85 per cent upon undistributed income except long-term capital gains, which are subject to a maximum rate of 25 per cent.

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[58] *Sunnen* v. *Commissioner,* 333 U.S. 591, 68 S. Ct. 715, 36 AFTR 611 (1948).

[59] See footnote 55.

[60] Courts are zealous in their efforts to make certain that form does not triumph over substance; *Higgins* v. *Smith,* 308 U.S. 473, 23 AFTR 800 (1939); *Gregory* v. *Helvering,* 293 U.S. 465, 14 AFTR 1191 (1934). See *Moline Properties, Inc.* v. *Commissioner,* 319 U.S. 436, 30 AFTR 1291 (1943). *Fontaine Fox,* 37 B.T.A. 271 (1938) and in many instances have ignored the separate entity of the corporation for tax purposes.

[61] See 1954 IRC § 544; 1939 IRC § 503 as to constructive ownership.

[62] 1954 IRC § 543(a)(1); 1939 IRC § 502(a)(b).

[63] 1954 IRC § 543(a)(5); 1939 IRC § 502(e). (Compensation for services performed by a

The accumulated earnings tax hurdle is briefly this: If your company accumulates its earnings beyond the reasonable needs of its business for the purpose of avoiding the surtaxes of the stockholders, it is subject to a penalty surtax of 27½ per cent or 38½ per cent. This is in addition to the regular corporate taxes. Personal holding companies are not subject to the accumulated earnings tax[64] nor are net long-term capital gains subject to this tax.[65]

Mere copyright or patent holding company. An author or inventor would gain nothing by organizing a corporation for the sole purpose of holding the copyright or patent and receiving the royalties. Were he to do so, it then would be a personal holding company. This would be true even if he were to make a gift of all of the stock in the company to his immediate family.

Patent development company. If the patentee and associates intend to finance the development of the patented product or process, a corporation may be more advisable than a partnership or joint venture. This is true not only for tax purposes, but for financing. If the income is substantial, the corporate rates may be lower than the individual surtax rates. The impact of the personal holding company or accumulated earnings tax provision can be controlled, if the income from the exploitation of one patent can be expended in research work on other inventions. The expenditures, to the extent that they are deductible, will offset the income from the developed patent. Eventually, if the corporation develops one or more patents with real value, the inventor and his financial backers can realize capital gains through the sale of the stock. (But see the paragraph below relating to Collapsible Corporations.) Of course, if the enterprise should fail, the corporate set-up will prove disadvantageous taxwise, because the loss will be a capital loss rather than an ordinary one.

Rentals v. royalties. A corporation can be used successfully for a patent that protects a piece of machinery. The machine can be leased, a method to be distinguished from granting a license to manufacture the machine. Almost all the income of the corporation will be derived from rentals rather than royalties. The personal holding company provisions cannot therefore be involved. Furthermore, the accumulated earnings tax is only a minor concern, since the rentals may be required to manufacture or acquire additional machines, or to finance improvements.

Other business plus royalties. If an author or inventor wishes to invest his royalties directly in some manufacturing or merchandising business rather than in securities, a corporation may be advisable. The corporation will own the copyright or patent, will receive the royalties, and expend them in the acquisition and operation of one or more businesses. So long as the gross income from the business is more than 20 per cent of the total income, the personal holding company

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corporation under contract if some person other than the corporation has the right to designate the individual who is to perform the services or if the individual is designated in the contract, and such individual owns 25 per cent or more of the corporation's stock.)

[64] 1954 IRC § 532(b); 1939 IRC § 102(a).

[65] 1954 IRC 535(b)(6); 1939 IRC § 102(d)(1)(D).

provisions will not be applicable. The same result can be accomplished through investments in income-producing real estate.

Collapsible corporations. In using a corporation care should be exercised to avoid the possible effect of the collapsible corporation provisions.[66] If applicable, these provisions convert gain on a sale of stock or liquidation of a corporation from capital gain to ordinary income. However, the Internal Revenue Code definition of the term "collapsible corporation" contains many conditions and limitations to safeguard the ordinary business transaction, and as a consequence a corporation's affairs may normally be arranged to bring the corporation outside the scope of the definition.

8. How to Treat Foreign Income of U.S. Citizens and Residents

Generally speaking, United States citizens and alien residents of the United States are subject to United States income tax on income from all sources, including income from foreign countries. An important exception for U.S. citizens relates to compensation earned outside the United States. To qualify, the taxpayer must be a bona fide resident of a foreign country or must be physically present in a foreign country or countries for at least 510 days of a consecutive 18-month period. In the latter case, the exemption is limited to $20,000 of compensation for the taxable year if the 18-month period includes the taxpayer's entire taxable year.

Citizens and residents of the United States who derive income from foreign sources, and who pay foreign taxes on such income, may deduct such taxes in determining net income subject to United States income tax, or may take such foreign taxes as a credit against the United States income tax.[67]

A citizen of the United States is allowed this credit regardless of the identity of the foreign country imposing the tax. An alien resident of the United States, however, may utilize the credit only if the foreign country of which the alien is a citizen allows a similar credit to citizens of the United States residing within its borders.

Some typical tax conventions that the United States has entered into with foreign countries are discussed below. Aside from the credit allowed by the United States for foreign taxes paid by residents, the treaties between the United States and the foreign countries contain provisions granting special treatment to various categories of income derived from the foreign countries. The table on pages 1545-1547 indicates how types of income of particular interest to professional people, derived from foreign sources by citizens and residents of the United States, are treated by the foreign countries with which the United States has entered into tax conventions.

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[66] 1954 IRC § 341; 1939 IRC § 117(m).

[67] 1954 IRC § 901; 1939 IRC § 131. See 1954 IRC § 904 for limitations on the credit.

TAX ON FOREIGN INCOME OF U.S. CITIZENS

SOURCE OF INCOME AND TAXING AUTHORITY	FOREIGN TAX ON ROYALTY INCOME DERIVED BY U.S. RESIDENTS FROM PATENTS AND COPYRIGHTS	FOREIGN TAX ON INCOME FROM PERSONAL SERVICES PERFORMED BY U.S. RESIDENTS
Canada[68]	Royalties from copyright, literary, dramatic, musical, or artistic work (excluding motion picture films) exempt if taxpayer not engaged in business in Canada through a permanent establishment.[69] Tax on patent and other royalties limited to 15 per cent if taxpayer has no permanent establishment in Canada.[70]	Exempt if taxpayer present in Canada for not more than 183 days in aggregate, and (a) compensation received as employee of resident or other entity of U.S. and (b) compensation does not exceed $5,000.[71] A professor or teacher, a resident of U.S., may be temporarily present in Canada for a period of not more than two years, and be exempt from Canadian tax on his teaching earnings.[72]
United Kingdom[73]	Exempt, if subject to U.S. tax and if taxpayer is not engaged in trade or business in United Kingdom.[74]	Exempt, if taxpayer (a) is present in the United Kingdom for not more than 183 days in aggregate, and (b) services are performed for resident of United States.[75] Exemption applicable to earnings of public entertainers, such as actors, musicians, athletes, etc.[76] A professor or teacher from the United States can teach in the United Kingdom for a period of two years and not be subject to United Kingdom tax on the income earned.[77]
France[78]	Exempt if taxpayer has no permanent establishment in France.[79]	Personal service income exempt if taxpayer (a) is present in France for an aggregate period of less than the taxable year and (b) services performed for resident or other entity of U.S. Professional services taxable only if professional activity has fixed center in France.[80]
Sweden[81]	Exempt[82]	Taxable where services are rendered, but exempt from Swedish tax if taxpayer is (a) temporarily present in Sweden for not more than 180 days and

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[68] Effective January 1, 1941, Article XXII of Convention. T.D. 5206, 1943 C.B. 526. A supplementary Income Tax Convention is effective for taxable years beginning after December 31, 1950. Article II of Supplementary Convention.

[69] Article XIII C.

[70] Article XI, 1.

[71] Article VII.

[72] Article VIII A.

[73] Convention with United Kingdom effective, as regards United States tax, for taxable years beginning on or after January 1, 1945, Article XXIII, (2)(a) of Convention. T.D. 5569, 1947-2 C.B. 100. As regards United Kingdom income tax, surtax and excess profits tax, the effective dates are respectively the year of assessment beginning April 6, 1945, the year of assessment beginning April 6, 1944 and any chargeable accounting period beginning on or after April 1, 1945, Article XXIII, (2)(b).

[74] Article VIII, (2).

[75] Article XI, (2).

[76] Article I of Protocol to Convention.

[77] Article XVIII.

[78] Effective January 1, 1945, T.D. 5499, 1946-1 C.B. 134. A supplementary convention and a supplementary protocol with France have been ratified, effective January 1, 1950.

[79] Article 7.

[80] Article 9 and Article 10.

[81] Effective January 1, 1940. T.D. 4975, 1940-2 C.B. 43.

[82] Article VI.

TAX ON FOREIGN INCOME OF U.S. CITIZENS (*Cont.*)

SOURCE OF INCOME AND TAXING AUTHORITY	FOREIGN TAX ON ROYALTY INCOME DERIVED BY U.S. RESIDENTS FROM PATENTS AND COPYRIGHTS	FOREIGN TAX ON INCOME FROM PERSONAL SERVICES PERFORMED BY U.S. RESIDENTS
		services are performed for U.S. entity, or (b) temporarily present for not more than 90 days and compensation does not exceed $3,000. Exemption not applicable to the professional earnings of such individuals as actors, artists, musicians, and professional athletes.[83]
Denmark[84]	Exempt if taxpayer has no permanent establishment in Denmark.[85]	Taxable where services are rendered but exempt from Danish tax if taxpayer is (a) temporarily present in Denmark for not more than 180 days and services are performed for a U.S. entity, or (b) temporarily present for not more than 90 days and compensation does not exceed $3,000.[86] A professor or teacher, a resident of the U.S., may be temporarily present in Denmark for a period of not more than 2 years, and be exempt from Danish tax on his teaching earnings.[87]
Netherlands[88]	Exempt if taxpayer is not engaged in trade or business in the Netherlands through a permanent establishment.[89]	Exempt from Netherlands tax if compensation is for services performed within Netherlands and if taxpayer (a) is temporarily present in Netherlands for not more than a total of 183 days in year, and (b) performs services for U.S. entity that bears actual burden of remuneration.[90] An exemption is provided from Netherlands tax on teaching earnings by U.S. teachers or professors teaching during a visit of not more than 2 years in the Netherlands under agreements for the exchange of teachers.[91]
New Zealand[92]	Taxpayer may elect to be subject to New Zealand tax on a net basis, as if engaged in trade or business in New Zealand through a permanent establishment therein.[93] Rentals for motion picture films exempt if taxpayer not engaged in business in New Zealand through permanent establishment.[94]	Exempt if taxpayer present in New Zealand for not more than 183 days in aggregate, and services are performed for person resident in U.S.[95] A professor or teacher, resident of U.S., may be temporarily present in New Zealand for a period of not more than two years, and be exempt from New Zealand tax on his teaching earnings.[96]

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[83] Article XI.

[84] Effective January 1, 1948 as regards U.S. taxes and April 1, 1948 as regards Danish taxes.

[85] Article VIII.

[86] Article XI.

[87] Article XIV.

[88] Effective January 1, 1947.

[89] Article IX.

[90] Article XVI.

[91] Article XVII.

[92] Effective for taxable years beginning after December 31, 1950 as regards U.S. taxes and for year of assessment beginning April 1, 1952 as regards New Zealand taxes.

[93] Article VII.

[94] Article VIII.

[95] Article IX.

[96] Article XIV.

TAX ON FOREIGN INCOME OF U.S. CITIZENS (*Cont.*)

SOURCE OF INCOME AND TAXING AUTHORITY	FOREIGN TAX ON ROYALTY INCOME DERIVED BY U.S. RESIDENTS FROM PATENTS AND COPYRIGHTS	FOREIGN TAX ON INCOME FROM PERSONAL SERVICES PERFORMED BY U.S. RESIDENTS
Norway[97]	Exempt if taxpayer does not have a permanent establishment in Norway.[98]	Exempt if taxpayer present in Norway for not more than 183 days during taxable year and (a) services performed for resident or entity of U.S. or (b) compensation does not exceed $10,000.[99] A professor or teacher, resident of U.S., may temporarily visit Norway for a period of not more than two years, and be exempt from Norway tax on his teaching earnings.[100]
Ireland[101]	Exempt if taxpayer not engaged in trade or business in Ireland.[102]	Exempt if taxpayer is present within Ireland for not more than 183 days in aggregate and services performed for person resident in U.S.[103] A professor or teacher, resident of U.S., may temporarily visit Ireland for a period of not more than two years, and be exempt from Ireland tax on his teaching earnings.[104]
Switzerland[105]	Exempt if taxpayer does not have a permanent establishment in Switzerland. This exemption applies also to rentals for motion picture films and industrial, commercial or scientific equipment.[106]	Exempt if taxpayer temporarily present in Switzerland for not more than 183 days during taxable year and (a) services performed for resident or entity of U.S. or (b) compensation does not exceed $10,000.[107] A professor or teacher, resident of U.S., may temporarily visit Switzerland for a period of not more than two years, and be exempt from Swiss tax on his teaching earnings.[108]
Union of South Africa[109]	No provision.	Exempt if taxpayer present within Union of South Africa for not more than 183 days, and (a) services performed for resident of U.S. and (b) income subject to U.S. tax.[110] A professor or teacher, a resident of U.S., who visits Union of South Africa for a period of not more than two years, is exempt from South African tax on his teaching earnings.[111]

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[97] Effective for taxable years beginning after December 31, 1950.

[98] Article VII.

[99] Article X.

[100] Article XII.

[101] Effective for taxable years beginning after December 31, 1950 in regard to U.S. taxes, and in accordance with the terms of Article XXII (2) (b) of the Convention in regard to Irish taxes.

[102] Article VIII.

[103] Article XI.

[104] Article XVIII.

[105] Effective for taxable years beginning after December 31, 1950.

[106] Article VIII.

[107] Article X.

[108] Article XII.

[109] Retroactively effective with respect to income arising on or after July 1, 1946, except certain articles of Protocol which are effective on and after July 1, 1948.

[110] Article II of Protocol.

[111] Article IX.

9. How to Treat United States Income of Nonresident Aliens

Generally speaking, nonresident aliens not engaged in trade or business within the United States and not at any time during the taxable year physically present therein are taxable only on fixed or determinable annual or periodical income from sources within the United States.[112] If such income amounts to $15,400 or less, no deductions,[113] exemptions,[114] credits for United States bond interest[115] or credits against United States tax[116] are allowed. The income is subject to a 30 per cent withholding tax by the United States.[117] On the other hand, if such income exceeds $15,400, limited deductions, exemptions, and credits are allowed. The income is taxed at the same rates as the income of United States citizens. But the aggregate tax may not be less than 30 per cent of the gross income.[118]

Nonresident aliens engaged in trade or business within the United States are subject to United States tax not only on fixed or determinable annual or periodical income from United States sources, but also on gross income from United States sources.[119] Limited deductions,[120] exemptions,[121] and credits[122] are allowed, and the tax is imposed at the same rates as the tax upon United States citizens.[123]

Trade or business. The term "engaged in trade or business within the United States" includes the performance of personal services therein. The term does not include personal services performed for a nonresident alien individual, foreign partnership, foreign corporation not engaged in trade or business within the United States, or office maintained by a domestic corporation in a foreign country or U.S. possession, if the nonresident alien who performs the services is temporarily present in the United States for a total of not more than 90 days during the taxable year, and if his compensation for such services does not exceed $3,000 in the aggregate. The term also does not include the effecting of transactions in the United States in commodities, stocks, or securities through resident brokers.[124]

Periodical income. The phrase "fixed or determinable annual or periodical" income includes such types of income as interest, dividends, rents, salaries, wages, premiums, annuities, compensation, remunerations, emoluments, and royalties.

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[112] 1954 IRC § 871(a)(1); 1939 IRC § 211(a)(1)(A).

[113] Reg. 118, § 39.213-1(a)(1).

[114] Reg. 118, § 39.214-1(a)(1).

[115] Footnote 114, above.

[116] 1954 IRC 874(c); 1939 IRC § 216.

[117] Footnote 112, above.

[118] 1954 IRC § 871(b)(3); 1939 IRC § 211(c).

[119] 1954 IRC § 871(c); 1939 IRC § 211(b). The determination of the source of income is to be made in accordance with 1954 IRC § 861; 1939 IRC § 119.

[120] 1954 IRC § 873; 1939 IRC § 213.

[121] Reg. 118, § 39.214-1(b)(2).

[122] Reg. 118, § 39.211-7(c).

[123] Footnote 122, above; 1954 IRC § 871(c).

[124] 1954 IRC § 871(c); 1939 IRC § 211(b).

It does not include (with certain exceptions) profit derived from the sale of either real or personal property within the United States.[125]

Sales of property. Nonresident aliens not engaged in trade or business within the United States and not at any time during the taxable year physically present therein are taxable only on fixed or determinable annual or periodical income from United States sources. Profit derived from the sale of property in the United States is not such income. (But see footnote 120.) However, if a nonresident alien is present in the United States at the time of a sale or exchange of a capital asset therein, he is taxable on the gain.[126] Furthermore, if he is present for an aggregate of ninety days or more during his taxable year, he is taxable on all gains derived from sales or exchanges of capital assets in the United States during such year even if made during his absence.[127] (However, under some of the tax conventions a complete exemption is granted from U.S. tax on capital gains realized by non-resident aliens.) Thus it would appear that a nonresident author who is not present in the United States at the time of a sale or for ninety days during a taxable year is not taxable by the United States on gain realized from the sale of a copyright in the United States.[128] To qualify for the exemption, the transaction must meet the requirement that there be a sale, rather than a mere licensing of the copyright.[129]

The general treatment of income realized by nonresident aliens from within the United States is provided for in the Code. In addition, the tax conventions discussed in Section 8 treat of the taxation of nonresident aliens who derive income from United States sources and who reside in countries with which the United States has entered into treaties. The table below indicates how such nonresidents are taxed by the United States on types of income of particular interest to professional people which is derived from sources within the United States.

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[125] Reg. 118, § 39.212-1(a); however, 1954 IRC § 871(a) includes lump sum distributions from exempt profit sharing and pension plans, and proceeds from the sale of timber and patents within the definition of "fixed or determinable annual or periodical" income.

[126] 1954 IRC § 871(a)(2)(A); 1939 IRC § 211(a)(1)(B).

[127] *Ibid.*

[128] Footnotes 125, 126 and 127, above. 1954 IRC § 871(a)(1) treats as taxable proceeds from the sale of a patent qualifying under § 1235.

[129] *Sabatini* v. *Commissioner,* (2 Cir. 1938) 98 F. 2d 753, 21 AFTR 800; *Sax Rohmer,* 5 T.C. 183 (1945). In the latter case the Tax Court held that a lump sum payment for American and Canadian serial rights was royalty income taxable as fixed or determinable annual or periodical income within the meaning of 1939 IRC § 211(a), inasmuch as the transaction amounted to a licensing arrangement rather than a sale. In this connection see also *Commissioner* v. *Wodehouse* (1949) 337 U.S. 369, in which lump sum payments for United States serial and book rights were held to be taxable under 1939 IRC § 211(a). The majority opinion in this case held that the payments were made for the use of copyrights in the United States and as such were taxable under 1939 IRC § 211(a). No determination was made by the Court as to whether the granting of book publishing and serial rights amounts to a license rather than a sale. Moreover, the reasoning employed in the majority opinion might conceivably be extended to hold that the proceeds of the sale of an entire copyright by a nonresident alien are taxable as "payments made to nonresident aliens for the use of patents or copyrights in the United States." As to what constitutes a sale see also footnote 44, above.

TAX ON U.S. INCOME OF NONRESIDENT ALIENS

COUNTRY OF RESIDENCE	U.S. TAX ON ROYALTY INCOME DERIVED BY ALIEN FROM PATENTS AND COPYRIGHTS	U.S. TAX ON INCOME FROM PERSONAL SERVICE PERFORMED BY ALIEN	U.S. CAPITAL GAINS TAX
Canada[130]	Royalties from copyright, literary, dramatic, musical or artistic work (excluding motion picture films) exempt if taxpayer not engaged in business in U.S. through a permanent establishment.[131] Tax on patent and other royalties limited to 15 per cent if taxpayer has no permanent establishment in the U.S.[132]	Exempt if taxpayer present in U.S. for not more than 183 days in aggregate, and (a) compensation received as employee of resident or other entity of Canada, or (b) compensation does not exceed $5,000.[133] A professor or teacher, a resident of Canada, may be temporarily present in the United States for a period of not more than two years, and be exempt from U.S. tax on his teaching earnings.[134]	Exempt if taxpayer has no permanent establishment in United States.[135]
United Kingdom[136]	Exempt if subject to United Kingdom tax, and if taxpayer is not engaged in trade or business in the U.S.[137]	Exempt if taxpayer (a) is present in U.S. for not more than 183 days in aggregate, and (b) services are performed for residents of United Kingdom.[138] Exemption applicable to earnings of public entertainment such as actors, musicians, athletes, etc.[139]	Exempt if taxpayer is not engaged in trade or business in United States.[140]
France[141]	Exempt if taxpayer has no permanent establishment in U.S.[142]	Personal service income exempt if taxpayer (a) is present in U.S. for an aggregate period of less than the taxable year and (b) services performed for resident or other entity of France. Professional services taxable only if professional activity has fixed center in United States.[143]	Sales of stock, securities or commodities exempt if taxpayer has no permanent establishment in U.S.[144]
Sweden[145]	Exempt[146]	Taxable where services are rendered but exempt from U.S. tax if taxpayer is (a) temporarily present in U.S. for not more than 180 days and services are performed for Swedish entity, or (b) temporarily present for not more than 90 days and compensation does not exceed $3,000. Exemption not applicable to the professional earnings of such individuals as actors, musicians, and professional athletes.[147]	Exempt if no permanent establishment in U.S.[148]

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[130] Footnote 68, above.
[131] Footnote 69, above.
[132] Footnote 70, above.
[133] Footnote 71, above.
[134] Footnote 72, above.
[135] Article VIII.
[136] Footnote 73, above.
[137] Article VIII(1).
[138] Article XI(1).
[139] Footnote 76, above.
[140] Article XIV.
[141] Footnote 78, above.
[142] Footnote 79, above.
[143] Footnote 80, above.
[144] Article 11.
[145] Footnote 81, above.
[146] Footnote 82, above.
[147] Footnote 83, above.
[148] Article IX.

TAX ON U.S. INCOME OF NONRESIDENT ALIENS (*Cont.*)

COUNTRY OF RESIDENCE	U.S. TAX ON ROYALTY INCOME DERIVED BY ALIEN FROM PATENTS AND COPYRIGHTS	U.S. TAX ON INCOME FROM PERSONAL SERVICE PERFORMED BY ALIEN	U.S. CAPITAL GAINS TAX
Denmark[149]	Exempt if taxpayer has no permanent establishment in U.S.[150]	Taxable where services are rendered, but exempt from U.S. tax if taxpayer is (a) temporarily present in U.S. for not more than 180 days and services are performed for a Danish entity, or (b) temporarily present for not more than 90 days and compensation does not exceed $3,000.[151] A professor or teacher, a resident of Denmark, may be temporarily present in the United States for a period of not more than two years, and be exempt from United States tax on his teaching earnings.[152]	No provision.[153]
Netherlands[154]	Exempt if taxpayer is not engaged in trade or business in U.S. through a permanent establishment.[155]	Exempt from U.S. tax if compensation is for services performed within U.S. and if taxpayer (a) is temporarily present in U.S. for not more than total of 183 days in year, and (b) performs services for Netherlands entity that bears actual burden of remuneration.[156] An exemption is provided from United States tax on teaching earnings by Netherlands teachers or professors teaching during a visit of not more than two years in the U.S. under agreements for the exchange of teachers.[157]	No provision.[158]
New Zealand[159]	Taxpayer may elect to be subject to U.S. tax on a net basis, as if engaged in trade or business within the U.S.[160] Rentals for motion picture films exempt if taxpayer not engaged in business in U.S. through permanent establishment.[161]	Exempt if taxpayer present in U.S. for not more than 183 days in aggregate, and services are performed for a person resident in New Zealand.[162] A professor or teacher, resident of New Zealand, may be temporarily present in the U.S. for a period of not more than two years, and be exempt from U.S. tax on his teaching earnings.[163]	No provision.

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[149] Footnote 84, above.

[150] Footnote 85, above.

[151] Footnote 86, above.

[152] Footnote 87, above.

[153] Article XII of the Convention, as originally promulgated, relating to exemption of capital gains, was not accepted by the United States at the time of ratification.

[154] Footnote 88, above.

[155] Footnote 89, above.

[156] Footnote 90, above.

[157] Footnote 91, above.

[158] Article XI of the Convention as originally promulgated, relating to exemption of capital gains, was not accepted by the United States at the time of ratification.

[159] Footnote 92, above.

[160] Article VII.

[161] Article VIII.

[162] Article IX.

[163] Article XIV.

TAX ON U.S. INCOME OF NONRESIDENT ALIENS (*Cont.*)

COUNTRY OF RESIDENCE	U.S. TAX ON ROYALTY INCOME DERIVED BY ALIEN FROM PATENTS AND COPYRIGHTS	U.S. TAX ON INCOME FROM PERSONAL SERVICE PERFORMED BY ALIEN	U.S. CAPITAL GAINS TAX
Norway[164]	Exempt if taxpayer does not have a permanent establishment in U.S.[165]	Exempt if taxpayer present in U.S. for not more than 183 days during taxable year and (a) services performed for resident or entity of Norway or (b) compensation does not exceed $10,000.[166] A professor or teacher, resident of Norway, may temporarily visit U.S. for a period of not more than two years, and be exempt from U.S. tax on his teaching earnings.[167]	No provision.
Ireland[168]	Exempt, if not engaged in trade or business in U.S.[169]	Exempt if taxpayer is present within U.S. for not more than 183 days in aggregate and services performed for person resident in Ireland.[170] A professor or teacher, resident of Ireland, may temporarily visit U.S. for a period of not more than two years, and be exempt from U.S. tax on his teaching earnings.[171]	No provision[172]
Switzerland[173]	Exempt if taxpayer does not have a permanent establishment in U.S. This exemption applies also to rentals for motion picture films and industrial, commercial or scientific equipment.[174]	Exempt if taxpayer temporarily present in U.S. for not more than 183 days during taxable year and (a) services performed for resident or entity of Switzerland or (b) compensation does not exceed $10,000.[175] A professor or teacher, resident of Switzerland, may temporarily visit U.S. for a period of not more than two years, and be exempt from U.S. tax on his teaching earnings.[176]	No provision
Union of South Africa[177]	No provision	Exempt if taxpayer present within U.S. for not more than 183 days, and (a) services performed for resident of Union of South Africa and (b) income subject to Union of South Africa tax.[178] A professor or teacher, resident of Union of South Africa, who visits U.S. for a period of not more than two years, is exempt from U.S. tax on his teaching earnings.[179]	No provision

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[164] Footnote 97, above.

[165] Article VII.

[166] Article X.

[167] Article XII.

[168] Footnote 101, above.

[169] Article VIII.

[170] Article XI.

[171] Article XVIII.

[172] Article XIV of the Convention as originally promulgated, relating to exemption of capital gains, was not accepted by the United States at the time of ratification.

[173] Footnote 105, above.

[174] Article VIII.

[175] Article X.

[176] Article XII.

[177] Footnote 109, above.

[178] Article II of Protocol.

[179] Article IX.

10. How to Treat Paid Charitable Performances

Situations arise in which an actor, author or other professional agrees to perform services for the benefit of a charity. On occasions such services are performed for a third party employer, such as a radio sponsor, with the understanding that the payments made by the sponsor are to become the property of the charity. It makes no difference to the sponsor whether payment is made directly to the charity or to the actor or author, who would in turn pay over the proceeds to the charity. It is possible, however, that the different methods of payment could have a substantial effect on the income tax liability of the professional.

If the payment is in the first instance made to the professional, or even directly to a charity by a paying employer who has hired the professional, the amount received must be included in the professional's income.[180] The payment to the charity will result in a deduction on the professional's income tax return, limited however to 20 per cent or 30 per cent of his adjusted gross income when added to all his other charitable contributions for the year. Once the 20 per cent or 30 per cent limitation, as the case may be, has been reached, taxable income will be realized without an offsetting deduction for the charitable contribution.

One possible solution to this problem would appear to be an arrangement under which the professional agrees to work for the charity for nothing. The charity may then sell his services to a third party for a fee. Under such an arrangement it would appear that the professional receives no taxable income. However, the Bureau has ruled that such an arrangement entered into to avoid the percentage limitation on the deduction for charitable contributions will be held to be ineffective,[181] and as a consequence, a professional employing the arrangement must be prepared for possible conflict with the taxing authorities.

11. How to Deduct Professional Expenses

All "ordinary and necessary expenses" in carrying on a profession are deductible. These expenses cover a wide range of items including (1) cost of supplies used in the profession, (2) cost of operation and repair of an automobile so used, (3) dues to professional societies and subscriptions to professional journals, (4) rent for office space, (5) fuel, light, water, telephone, (6) wages of office assistants, (7) entertainment expenses, and (8) expenses incurred attending conventions and meetings of professional societies including travel and hotel expenses.

Where a person carrying on a profession maintains an office in his home, expenses of maintaining the residence reasonably allocable to the office are deductible. The allocation must be made on a reasonable basis, for example, on space. If a doctor owns a seven-room house and uses one room which constitutes 1/7 of the space in the house as an office, he may deduct 1/7 of such items as painting, repairs, depreciation, upkeep of grounds, water and sewer rents, expenses of cleaning, insurance, etc. If a separate telephone is not maintained for office use, a reasonable portion of telephone expenses, depending on business use of the telephone, is deductible.

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[180] Reg. 118, § 39.22(a)-2.

[181] Rev. Rul. 71, 1953-10. Under this ruling the Commissioner took the position that the payment from a sponsor to a charity for services performed by a professional would be effective to avoid the percentage limitation only where the professional "is under contract of employment or other obligation entered into in good faith for purposes other than avoidance of the percentage limitation imposed on the deduction of contributions . . . and as an incident of his normal duties and obligations, his employer or other superior makes his services available to a third party, payment being made to the employer or other superior."

Cost of uniforms and other clothing worn by doctors, dentists and actors, which do not take the place of ordinary clothing and is required to carry on a profession, is deductible. Actors may deduct the cost of wigs, shoes, costumes, and accessories if the useful life of these items does not extend over more than one year. If the useful life extends over more than one year, such items may be depreciated. The same is true of books and other equipment purchased in carrying on a profession.

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What Are Adequate Records for the Preparation of Income Tax Returns

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The always troublesome problem of keeping adequate records for income tax purposes has now assumed added importance by reason of the more vigorous and critical audit policies of the Internal Revenue Service since its reorganization In this chapter the record keeping problem of the individual taxpayer who is not the proprietor of a business will be considered in some detail. Taxpayers conducting businesses and professions generally have reasonably adequate books of account and other fiscal records maintained by competent persons.

1. Points to Consider

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The applicable statutes, regulations and rulings 2
Practical necessity for adequate records even where not expressly required by statute, regulations or rulings 3
Commissioner's power to determine income by arbitrary methods in absence of adequate records 4
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2. The Statutes, Regulations and Rulings Relating to Keeping of Records

The Internal Revenue Code of 1954, Section 6001 compels all taxpayers to keep such records as the Secretary of the Treasury or his delegate shall specifically require and the willful failure to keep such records (where required) constitutes a misdemeanor.[1]

The Regulations do not compel a uniform method of accounting by all taxpayers but permit the adoption of systems of accounting which in the judgment of each taxpayer are best adapted to his particular situation.[2] He must, however, maintain such accounting records as will enable him "to make a return of his true income." [3] The Regulations require all taxpayers other than taxpayers "whose gross income (1) consists solely of salary, wages, or similar compensation for personal services rendered, or (2) arises solely from the business of growing and selling products of the soil [to] . . . keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of the gross income and the deductions, credits and other matters required to be shown in" their income tax returns.[4] The requirements set forth in the Revenue Code and Regulations are neither comprehensive nor clear and do not indicate the particular records the millions of taxpayers whose income is derived from wages, salaries and commissions shall maintain.

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[1] 1954 IRC § 7203, under which a fine of $10,000., or imprisonment up to one year, or both, may be imposed.

The Tax Court has held that the 50 per cent fraud penalty would not be imposed where the taxpayer had kept inadequate records; that ignorance of bookkeeping methods and poor judgment were not the equivalent of fraud.[5]

Apart from the severe criminal penalties mentioned above, the failure to maintain proper records resulting in underpayment of tax may subject the taxpayer to the negligence penalty.[6] The Tax Court has approved the imposition of the negligence penalty where there was a flagrant disregard of the record-keeping requirement.[7] In *Julian A. Martin,*[8] the negligence penalty was held to have been properly imposed where the taxpayer's deductions had been overstated or exaggerated and no books of account, check stubs or other records were maintained.

The provisions of the Regulations expressly exempting wage and salary earners from keeping "permanent books of account or records" [9] are not applicable where such a taxpayer also has taxable income from the sale of real estate.[10]

3. Practical Necessity for Adequate Records Even Where Not Expressly Required by Statute, Regulations or Rulings

Regardless of the fact that large classes of taxpayers are not expressly required by statute, regulation or ruling to maintain records in respect of their income, deductions, credits and exemptions, the courts will sustain deficiencies based upon inadequate records except to the extent that the doctrine of the *George M. Cohan* case may be availed of by the taxpayer. The courts' requirement of such records if the taxpayer is to sustain his burden of proof is well illustrated by the Tax Court's opinion in *John T. Scurlock*[11] where it said:

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[2] Reg. 118, § 39.41-3.

[3] *Supra,* note 2; see Commissioner's Reorganization Order No. 23 dated September 11, 1953 which authorizes the District Directors "to require any person, by notice served upon him, to keep such records as shall show whether or not such person is liable to the income tax . . . and the correct amount of income subject to tax." See also 1951 IRC Sec. 6001, permitting such notice ". . . whether or not such person is liable for tax . . ."

[4] Reg. 118, § 39.54.

[5] E. S. *Iley, et al.,* 19 T.C. 631 (1953).

[6] 1954 IRC § 6653(a). See also I.T. 1929, 111-1 C.B. 424.

[7] *Pusser* v. *Commissioner* (4 Cir. 1953), 206 F. 2d 68; *H. A. Hurley,* 22 T.C. No. 157 (1954); *Moss Industries,* 12 T.C.M. 317, Dkt. No. 32920 (1953); *Michael Markovits,* 11 T.C.M. 823, 843 (1952); *Spencer D. Lorton,* T.C. Memo. opin. P-H Para. 74,504 (1953); *Lena M. Buchwach,* 9 T.C.M. 835 (1950). Compare *Mary Sachs,* 11 T.C.M. 882 (1952), reversed on another point, 208 F. (2d) 313, where misleading account titles were held not to justify the negligence penalty.

[8] P-H T.C. Memo Dec. Para. 52,282 (1952), where the Court said: ". . . petitioner's claimed deductions were so overstated and exaggerated, particularly with respect to his deductions for charitable contributions, that he is chargeable with negligence. . . ."

[9] Reg. 118, § 39.54.

[10] *John T. Scurlock, et al.,* 9 T.C.M. 5 (1950); *Roy A. Fellows, et al.,* 9 T.C.M. 35 (1950).

> We think it clear that though under the regulation [Regulations 111, Section 29.54-1] the persons thereby excepted do not have to maintain records for the Commissioner's examination, it does not follow that such person, when under the burden of proving his case in court, is excused from such burden by the regulation, *for books and records may, in a proper case be the requisite proof;* . . . (italics added)

There is some comfort in the fact that the courts frequently sustain, at least in part, deductions made for business expenses and even other deductions, in the absence of records, receipts or cancelled checks under the doctrine of the *George M. Cohan* case, which was not legislatively changed by the new Revenue Code.[12] In that case, probably the most frequently cited in the entire tax field, the Court held that the Commissioner and the Board of Tax Appeals had erred in completely disallowing travel and other business expenses even where there were no records and that the Board was required to make "as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making." [13] It goes without saying, however, that taxpayers should strive to avoid situations calling for application of the Cohan rule—a court-made doctrine which the Internal Revenue Service always attempts to limit, frequently forcing taxpayers into the courts.

4. Commissioner's Power to Determine Income by Arbitrary Methods in Absence of Adequate Records

In the absence of adequate records, the Commissioner is permitted to apply rather arbitrary and frequently inaccurate methods to calculate the taxpayer's income.[14] The statutory sanction for such methods of estimating income where the taxpayer's records do "not clearly reflect income" is Section 446(c) of the 1954 Revenue Code, authorizing the computation of income ". . . under such method as in the opinion of the Secretary or his delegate does clearly reflect income." Among these methods for ascertaining a taxpayer's business income when his records do not adequately reflect his true income are: (1) comparison of the income from his business with the income from similar businesses (also sometimes called the "Percentage of Markup" method);[15] (2) computation of the increase in taxpayer's net worth for the taxable year after adding to such annual increase the estimated amount of his personal living expenses not reflected in such increase in net worth (sometimes described as the "Net Worth-Expenditures" method);[16] and (3) reconstructing taxpayer's gross income by substituting the aggregate amount of the taxpayer's bank deposits during the taxable year (after eliminating recognized non-income deposits) for the amount of income shown in the return.[17] This latter method is sometimes referred to as the "Analysis of Bank Deposits" method. Probably the "Increase in Net Worth Test" is the method most commonly used.[18]

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[11] See first case cited note 10.

[12] (2 Cir. 1930) 39 F. (2d) 540.

[13] 39 F. (2d) 540, 544. See *Frank L. Kluckhohn, et ux.*, 18 T.C. 892 (1952), where the taxpayer's records had been lost.

[14] *Bishoff* v. *Commissioner* (3 Cir. 1928), 27 F. (2d) 91.

[15] See *Harry A. Roberts*, 10 T.C. 581 (1948), affd. (9 Cir. 1949) 176 F. (2d) 221, where 10 per cent estimated tips were added to a taxi driver's taxable income; *Bishoff* v. *Commissioner, supra*, where earnings of similar businesses were used by the Commissioner in determining income; *Ray Gasper*, 12 T.C.M. 772, No. 32352 (1953), where percentage markup applied to beer sales.

The Supreme Court has recently sustained the propriety of income tax fraud prosecutions based upon net worth increases but with the caveat that it should only be applied with due regard for the taxpayer's rights. *Holland et ux* v. *United States,* 348 U.S. 121 (1954); *Smith* v. *United States,* 348 U.S. 147 (1954); *United States* v. *Calderon,* 348 U.S. 160 (1954). Use of the net worth method is proper even where the taxpayer's books of account are apparently accurate but a definite opening net worth figure must be established with reasonable certainty. *Holland et ux* v. *United States,* 348 U.S. 121 at pp. 130-135. In some instances more than one of these methods may be used with respect to a particular taxpayer.[19]

The importance of these arbitrary methods and their present wide-spread use is indicated by a recent note in the *American Bar Association Journal* [20] in which it is stated that out of 115 Tax Court cases decided between June and November, 1952 relating to the income taxes of individuals, 36 involved the issue of the amount of income received by the taxpayer. In these latter cases the Commissioner had applied the Net Worth-Expenditures method in 16 of the cases, the Analysis of Bank Deposits method in 5 of the cases and the Percentage of Markup method in 3 cases. The moral is that the taxpayer should avoid the possibility of application of such procedures by keeping at least the modicum of adequate records particularly in view of the fact that the necessity of applying such methods will probably result in close scrutiny of the taxpayer's returns in all future years.

5. Recommended Forms of Account Books and Other Records for General Purposes

Having found that all taxpayers must keep some sort of record of their income, exemptions, credits, and deductions, either by reason of statute or regulation or to sustain their returns upon audit, we shall consider specifically just what forms of account books and other records are best adapted to fulfill the needs of the average individual taxpayer who does not operate a business or professional office and is on the cash receipts and disbursements and calendar year basis of accounting.

The Commissioner and the courts stress the importance and reliability of the basic records of original entry which are kept contemporaneously by the taxpayer.[21]

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[16] *Kenney* v. *Commissioner* (5 Cir. 1940), 111 F. (2d) 374, where increase in net worth test applied to professional gambler who kept no records.

[17] *Lena Buchwach, supra.*

[18] See Rothwachs, "Criminal Tax Prosecutions," *Proc. N.Y.U. 8th Ann. Inst. on Fed. Taxation,* 252,260,274.

[19] See comprehensive analysis of all these various methods of reconstructing of income, entitled "Reconstruction of Net Income" Commerce Clearing House, August, 1953.

[20] *Amer. Bar Assoc. Journal,* Vol. 39, pp. 251-3 (1953).

[21] See, for example, *John J. Gough,* 11 T.C.M. 1022 (1952), where bar owner's records were held to be incomplete in the absence of cash register tape and daily cash receipts and disbursements records.

The records to be kept need not be elaborate or formal. Few ordinary taxpayers are willing or able to keep a set of double entry bookkeeping records. The very simplicity of the records should encourage the taxpayer to make the entries promptly as the income items are received and payments for deductible items are made. A suggested simple form of disbursements record which has proved helpful through the years to clients of the writer whose tax returns his office regularly prepares contains columns for recording check numbers, description of the items, and the categories into which the expenses fall: Charitable Contributions, Interest, Taxes, Casualty and Theft Losses, Medical and Dental Expenses, and Miscellaneous Expenses. A few moments each day or each week will enable the taxpayer using such a record to reduce to a minimum the often confused and hectic ordeal of attempting to bring together just before April 15 all the data and figures relating to his deductions for the past taxable year. The taxpayer should, in addition to keeping such a record, be strongly urged to keep in a separate file for each year, separate envelopes marked with the names of the various categories of deductions shown on the disbursements record and consistently place in them the receipted bills and cancelled checks supporting the deductions.

It does not seem necessary in the case of the average individual taxpayer to keep similar detailed records showing all the various kinds of income received, inasmuch as the data covering income is relatively easily ascertained and assembled at income tax time (as to dividend records, however, see Section 6 of this Chapter).

6. Records for Security Transactions

Where the taxpayer owns securities it is essential for him to keep, preferably in a small bound single entry account or memorandum book for each year, a contemporaneous record of dividend and interest payments, listing them on separate pages under the names of the payor for totaling and inclusion in the tax return. This is of vital importance to the taxpayer since enactment of Sections 116 and 34(a) of the 1954 Revenue Act permitting a $50. exclusion and a 4 per cent credit against tax in respect of dividends received from domestic corporations.

Where the taxpayer owns securities for investment the importance of his maintaining a record of purchases (with cross references to retained broker's tickets) cannot be overestimated. The brokers' sales tickets for the current year are usually carefully preserved until the succeeding return filing date but the purchase tickets are all too frequently lost or mislaid. (It is recommended that the purchase tickets be pinned to the stock certificates themselves.) Not only will the serious problem of proving his cost basis[22] for the securities be eliminated, but such a record will enable the taxpayer to avoid the frequently disadvantageous application of the "first in, first out" rule[23] and thus enable him to sell the particular lots of stock which will result in the smallest amount of gain or the largest loss regardless of the dates of purchase. There is available at many stationers' shops a simple form of record which adequately describes the particular security, its purchase price, sales price and the dates thereof.

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[22] See *Jankowsky* v. *Commissioner* (10 Cir. 1932), 56 F. (2d) 1006, where taxpayer's loss on securities disallowed because proof of cost basis was lacking.

[23] Reg. 118, § 39.22(a)-8.

7. Records of the Home Owner

The owner of a personal residence should keep careful account of all his capital expenditures covering the original acquisition and improvement of his home inasmuch as this information will be required not only in proving his adjusted cost basis on any subsequent sale of the home at a profit but also to prove such adjusted cost basis as of the time immediately preceding the date of a casualty loss.[24] All too frequently, on a sale many years after the date of purchase the taxpayer fails, at least in part, to prove his expenditures for alterations, additions and improvements to his home with consequent larger capital gain.

It is recommended that a simple *bound* single entry account or memorandum book be systematically maintained including not only the original cost of purchase, survey, title search, attorney's fees, etc. but also all expenses of permanent improvements, alterations and additions (and costs of improvements in anticipation of sale if purchase of another residence is anticipated). Likewise in a separate folder there should be permanently kept (not just merely for the usual statute of limitations period) all the cancelled checks and receipted bills covering each expenditure and, in addition, the attorney's closing statements, real estate broker's bill, and record of Federal stamp taxes covering the acquisition and eventual sale of the home.

Where the home owner has suffered a casualty loss[25] it is highly desirable to prepare for the almost inevitable audit of such loss deductions by having adequate photographs available showing the property both before and after the fire or storm as well as a contemporaneous affidavit of a competent real estate broker acquainted with the taxpayer's home and values in the locality stating the diminution in market value resulting from the casualty. Such affidavit should also include in the diminution of value figure the cost of removing the debris of the storm or fire. Where such an affidavit is obtained two or three years after the casualty has occurred it has been the writer's experience that it carries less weight with the Internal Revenue Service.

8. Records Covering Travel and Entertainment Expense

Where the taxpayer's business is of such a nature that travelling and entertainment expenses constitute substantial items, the matter of proving them constitutes a very serious problem. Spokesmen for the Internal Revenue Service have publicly stated on several occasions during the past two years that such items of expense are to be carefully scrutinized on audit. Increasingly such expenses are being severely criticized in the absence of convincing contemporaneous records.

It is important to maintain where there is heavy travelling and entertainment expense (in addition to the record sheet hereinafter mentioned) a day-by-day journal or diary in which are contemporaneously entered the places visited and the names and identities of the persons entertained. This should also include entertainment in the taxpayer's own home. There has recently arisen a practice on the part of restaurants and clubs in the larger cities of permitting the charging of such items and having a detailed statement rendered. This practice may prove very useful, if not essential, in substantiating such expenditures. If your employer requires you to do such entertaining, retain any correspondence with him in your income tax files on the subject.

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[24] 1954 IRC § 165(c)(3); *Helvering* v. *Owens*, 305 U.S. 468.

[25] See preceding footnote.

In addition to such a day-by-day journal or diary, it is suggested that the taxpayer should, for purposes of easy assembling of his data at income tax time, keep a daily record on columnar paper identifying the expenditure, indicating the date thereof, and classifying it. For the purpose of classification, the following column headings are suggested as being useful: Railroad Tickets, Air and Steamship Tickets, Auto Travel Expense, Baggage Expense, Hotels, Restaurants While Traveling, Entertainment: at Theatres, in Home, in Hotels and Restaurants, in Clubs, Gifts Given for Business Purposes. A somewhat detailed and systematic breakdown of the types of entertainment expense on the return itself has often, in the writer's experience, proved helpful on audit in sustaining the deduction. The taxpayer should also maintain a folder for each year covering his expenditures for travel and entertainment with separate envelopes for each of the classes of expenditures listed in the suggested columns. Transportation companies do not usually issue receipts. It may be advisable to purchase the tickets through travel agencies who will issue receipts. In any event, railroad ticket envelopes and receipted hotel bills should be retained. Records should be kept of gasoline and oil purchased and the receipted statements preserved. If such records are not feasible, speedometer readings should also be made at the beginning and close of the year to serve as the basis for careful estimates as to the portion of the automobile expense deductible for business purposes. Such estimates, however, are subject to being carved down on audit.

The provisions of Section 62(2)(C) and (D) of the 1954 Revenue Code considerably liberalize the deduction of local transportation expenses and outside salesmen from gross adjusted income (without losing the standard deduction) and point up the absolute necessity of keeping adequate records if these new deductions are to be sustained.

It is frequently difficult as regards this type of expenditure to pay by check. In *Michael Markovits*,[26] checks payable to "cash" were held not to be satisfactory proof that they were in fact used for travel and entertainment expense. It has been the writer's experience (despite the holding in the *Markovits* case) that where it is impossible or difficult to pay such items by check or obtain a receipt, that if the checks for "cash" bear a marginal notation as to what they cover, although "self-serving," such notations may at least be given some weight by the Internal Revenue Service on audit.

9. Additional Records Made Necessary by 1954 Revenue Code

Section 163 of the new Revenue Code permits the deduction as interest of the finance, service or other carrying charges on installment purchases where the interest charge cannot be ascertained. This statute permits the deduction up to 6 per cent of the sum of the unpaid balances outstanding on the first day of each month divided by twelve. The obtaining of this deduction, of course, will require careful preservation of the monthly statements.

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[26] 11 T.C.M. 823, where the Court (at pp. 847-8) said: "It appears that the petitioner relies upon notations on check stubs to support his claim for deductions . . . evidenced by checks for 'cash.' But the check book notations are vague and show nothing other than the word 'Travel' or 'Entertainment.' Check stub notations of such general purport to explain checks made payable to 'cash' seldom, if ever, are regarded as adequate proof of a business expense deduction."

Section 105 of the 1954 Revenue Code permits the exclusion from income of payments in lieu of wages during a period of sickness or injury up to $100. per week. Careful records should be kept by the taxpayer covering the facts and figures with respect to such payments as well as the disability giving rise to such payments.

Section 214 of the 1954 Revenue Code permits the deduction up to $600. in one year for the cost of child care required to enable the taxpayer to be gainfully employed subject, however, to various restrictions. This deduction will, of course, require the keeping of records covering the payments made for such care.

10. How Long Should Records Be Kept

In view of the fact that the Statute of Limitations never runs where a return is not filed[27] and the burden of proof is placed on the taxpayer to prove the date of filing the return,[28] it seems advisable to retain indefinitely copies of the returns, letters of transmittal and all cancelled checks in payment of the tax liability. The writer has always recommended the practice of actually stapling the cancelled checks to the copies of the returns.

Although it has been held by the Court of Appeals for the Eighth Circuit[29] that failure to file an income tax return does not justify imposition of the civil fraud penalty under 1939 Code, Section 293(b) (1954 Code, Sec. 6653(b)), the other penalties and 6 per cent interest where taxpayer fails to prove he filed and paid may approximate a substantial sum.

In order to support proof of mailing the return and check in payment of the liability where the expense or inconvenience of registered mail (with return receipt requested) or delivery by messenger against stamped receipt on the letter of transmittal seems unjustified, it is recommended that the Post Office Department's recently inaugurated "certified mail" service might be used or the little known but readily available form of mailing receipt (Form 3817), costing one cent, might well be obtained as a precaution.

In recent years the records of the Internal Revenue Service in the District Director's offices relating to declaration payments have not always been made readily available to the audit personnel. This has made necessary, in many instances, the taxpayer's supplying photostatic copies of both sides of the cancelled checks in payment of the four quarterly installments on the declarations of estimated income tax liability. In view of this situation, it is essential that these checks also be carefully preserved and affixed to the declaration or return on which such payments are credited.

It is recommended that books and records, cancelled checks, check stubs, and receipted invoices and statements relating to income and deductions be kept for at least five years in view of the five-year statute of limitations on assessment of deficiencies where the taxpayer omits from gross income amounts in excess of 25 per cent of the amount of the gross income stated in the return.[30] Such records, of course, should be kept longer where the Statute has been extended by waiver.

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[27] 1954 IRC § 6501(c)(3).

[28] *Ardbern Company, Ltd.*, 41 B.T.A. 910,918 (1940), taxpayer's appeal dismissed, Oct. 15, 1941 (Cir. Dist. of Columbia).

[29] *First Trust & Savings Bank of Davenport, Iowa* v. *United States* (8 Cir. 1953), 206 F. 2d 97.

The objection that the retention for long periods of the taxpayer's records is costly and inconvenient is to some extent met by microfilm reproductions thereof which the Commissioner has ruled are acceptable as to the underlying documents, checks, etc. but not as to general books of account, journals, voucher registers, and ledgers.[31]

11. How the Tax Adviser Can Encourage Better Record Keeping

The lawyer or accountant who prepares the income tax return can encourage the keeping of more accurate and systematic records by his client if he supplies to his client, several weeks before April 15, a form of data sheet as the basis for preparation of the return. The writer has, each year for the past fifteen years, used such a data sheet (a copy of which applicable to the year 1952 is appended at the end of this Chapter as Exhibit A). This form is designed primarily for the taxpayer who is not in business for himself. He has found that it not only saves much time in prompt assembling by the taxpayer in one "package" of all the required data (instead of piecemeal in various letters, memoranda and telephone conversations) but also serves to remind the taxpayer of deductions sometimes overlooked and induces him in time to become more orderly and "record conscious." Moreover, if signed by the taxpayer, the lawyer or accountant preparing the return is afforded a considerable measure of protection from any penalties resulting from omission of income or improper or unfounded deductions.[32] Admittedly, this data sheet does not cover all situations and is perhaps oversimplified. It can be accompanied by a letter of transmittal in which particular reference can be made to the taxpayer's peculiar problems. In addition, a rider or supplement can be attached to the data sheet covering information required for preparation of the income tax return under the laws of the state where the particular taxpayer resides.

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[30] 1954 IRC § 6501(e)(1)(A).

[31] I.T. 3866, 1947-2 C.B. 68.

[32] As to the legal responsibility of the person preparing the return see 1954 IRC Sec. 7206(2) providing criminal penalties for wilfully counselling a false return or making false statements in a return. The declaration to be signed by the person preparing the return apparently makes him responsible only for information of which he has actual or constructive knowledge and not "for the truth and accuracy of information furnished to him for use in preparing the return where the verification of the information by the attorney or agent was not embraced in his employment to prepare the return." See G.C.M. 14509, XIV-1 C.B. 84. Use of qualifying statements by the person preparing the return is probably legally ineffective. See Reg. 118, § 39.51-4(b) and 28 *Taxes* 1077-9 (1950).

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EXHIBIT A

DATA FOR USE IN PREPARING 1955 FEDERAL INCOME TAX RETURN AND 1956 DECLARATION OF ESTIMATED TAX

(please fill out each item or mark "none")

Name: Home Address: Your Occupation:

Business Address: Wife's Occupation: Name of spouse: (If your spouse died, give date of death)

Your Federal Social Security No.: Spouse's Federal Social Security No.:

Are you or your spouse over 65 years of age or blind:

If over 65 years of age, list Social Security payments received by you or your spouse in 1955:

Your dependents (whose gross income was less than $600. in 1955 who received more than half his or her support from you):

(1) Name:	(2) Whether under 19 yrs. old or still in school (if dependent earned $600. or more):	(3) Whether supported in your home:	(4) Whether solely supported by you:	(5) Amount of support supplied by others or by dependent:

If unmarried throughout 1955 did you maintain your father or mother in your or a separate home or maintain in your own home any of the above mentioned dependents or any child, stepchild or grandchild (whether or not the latter were dependent on you) and pay over one-half cost of maintaining the household (if you did not pay entire cost of household, state total amount supplied (1) by you and (2) by all others):

In which Internal Revenue Service collection district were your and your spouse's 1954 Federal return and 1955 declaration of estimated tax filed:

Do you or your spouse owe any income taxes for any prior year (if so, please explain in a separate statement):

INCOME

Names and addresses of your employer or employers:

Gross Compensation from employer (including bonuses and tips) ***Husband*** ***Wife***

Income tax withheld by employer during 1955 (attach original withholding statements—Form W-2) ***Husband*** ***Wife***

Exclusions from salary or wages—list amounts paid by employer while sick or injured (but not in excess of $100 a week). Indicate whether you were hospitalized or injured during absence from work. ***Husband*** ***Wife***

Cash dividends (give total for each corporation and supply copies of communications in respect of status of dividends from mutual or investment funds and mining companies):

Name of paying corporation: ***Husband*** ***Wife***

Dividends paid in stock (attach any correspondence relating to such dividends):

Name of paying corporation. ***Husband*** ***Wife***

DATA FOR USE IN PREPARING 1955 FEDERAL INCOME TAX RETURN AND 1956 DECLARATION OF ESTIMATED TAX (*Cont.*)

Interest on bonds, notes, savings accounts, building and loan shares, tax refunds or other sources (other than from U.S. Government securities and municipal bonds):

Name of payor: *Husband* *Wife*

Interest on U.S. Government securities (placing a check mark alongside any issued before March 1, 1941): *Husband* *Wife*

Miscellaneous income from rents, royalties, annuities, pensions, director's or juror's fees, prize contests, alimony (or other support payments), partnerships, trusts, etc. (list separately and describe briefly) *Husband* *Wife*

CAPITAL GAINS AND LOSSES

List separately each sale of securities and real estate (including cooperative apartments); "expenses of Sale" includes brokers' commissions and *Federal* stock transfer taxes and, if real estate is sold, all costs of such sale such as attorneys' fees, broker's commissions and Federal stamp tax on deed.

Description	*Date of Purchase*	*Date of Sale*	*Gross Sales Price*	*Cost*	*Expenses of Sale*
	Husband				
	Wife				

Give total of any capital loss carry-over from prior five years: (How much of this total is carried over from the fifth year back):

Husband *Wife*

Give your share of any partnership capital gains and losses:

Husband: Long term (held for more than 6 months) $________ Short term $________

Wife: Long term: $________ Short term $________

List any securities or debts which you believe became worthless during 1955. (Supply any documents showing worthlessness):

If any income was derived from business operated by you, supply profit and loss statement for 1955, or, if none, set forth in a separate statement, the gross receipts from the business and payments for wages, rent, bad debts, repairs, postage, stationery, insurance, cost of materials, depreciation, and other expenses of doing business.

DEDUCTIONS (actually paid during 1955)

Charitable contributions (whether in cash or property), also including proportionate share of any partnership contributions:

Name and address of charity: *Husband* *Wife*

Interest paid (including interest on mortgages, all indebtedness, and tax deficiencies and carrying charges on installment purchases) *Husband* *Wife*

DATA FOR USE IN PREPARING 1955 FEDERAL INCOME TAX RETURN AND 1956 DECLARATION OF ESTIMATED TAX (*Cont.*)

Taxes: *Husband* *Wife*

State income tax actually paid during 1955 (including any additional liability)

Income taxes imposed by foreign countries

Real estate taxes

Personal property taxes

Sales taxes

Automobile or other use taxes

State stock transfer taxes

Gasoline taxes

Auto license plate and driver's fees

Doctors, Dentists, etc.: (Including charges of doctors, surgeons, dentists, psychiatrists, psychologists and nurses, eye glasses, arch supports, etc., transportation expense primarily for medical care, and hospital, surgical, and accident insurance premiums.)

Name and address: *Husband* *Wife*

Medicine and drugs (whether or not pursuant to prescription) *Husband* *Wife*

Miscellaneous deductions: List separately and explain briefly fire, theft, and storm losses (to extent unreimbursed by insurance), alimony or other support payments, your share of interest and taxes on cooperative apartment or cooperative housing corporation, child care expense, unreimbursed business expenses (including entertainment and local transportation expense other than for commutation), safe deposit box rental, custodian fees, and cost of investment and tax advice (including preparation of income tax returns, handling audits and refund claims).

Husband *Wife*

PAYMENTS ON 1955 DECLARATION OF ESTIMATED FEDERAL INCOME TAX

Total amounts paid on declaration on or prior to March 15, June 15, and September 15, 1955 and on or prior to January 15, 1956.

Husband *Wife*

(Supply copy of declaration and any amendments if we did not prepare)

DECLARATION OF ESTIMATED FEDERAL INCOME TAX FOR 1956

Give best present estimate of gross income for 1956:

Husband *Wife*

State briefly what, if any, changes are to be expected in your deductions and dependents during 1956

FEDERAL GIFT TAX

List all gifts during 1955 to any one person of more than $3,000. (whether in money or other property at current market value), indicating any gifts made in trust and which of the donees were infants.

Name and address of donee: *Husband* *Wife*

Dated, __________, ________, 1955 Signed: ____________________

Husband

____

Wife

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Citizens Living Abroad

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Constitutionally, the United States may tax citizens on gross income from all sources.[1] However, the Internal Revenue Code provides a number of exemptions and exclusions for specified types of income and taxpayers. This chapter is concerned with the exemption afforded to citizens of the United States who live in foreign countries.[2] It should be borne in mind that the applicable provisions of the Code have been subjected to major revisions in recent years. As a result, it will be necessary for the reader to study prior provisions of law when dealing with situations involving earlier years.

1. Points to Consider

	Section
How U.S. citizens living abroad may qualify for an exemption	2
Method I—The requirement of bona fide foreign residence	3
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2. How U.S. Citizens Living Abroad May Qualify for an Exemption

Section 911 of the Internal Revenue Code of 1954 provides two general methods by which an American citizen living in a foreign country may secure an exclusion for income which he has earned abroad.

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[1] 1954 IRC § 61; 1939 IRC § 22(a). In *Cook* v. *Tait*, 265 U.S. 47, 4 AFTR 3974 (1924), an American citizen residing and domiciled in Mexico was held subject to taxes from income on property located in Mexico. See Reg. 118, § 39.11-2. For a definition of "citizen," see Reg. 118, § 39.11-3.

[2] The primary statutory provision is 1954 IRC § 911; 1939 IRC § 116(a). See also 1954 IRC § 931; 1939 IRC §§ 4(g), 22(b)(8), and 251. "The exemption was made in the interest of foreign trade, to induce Americans to accept employment abroad and put American business on an equality with foreign competitors." *Swenson* v. *Thomas* (5 Cir. 1947), 164 F. 2d 783, 36 AFTR 461.

1. One method is for the individual to establish that he has been a bona fide resident of a foreign country or countries for a period including an entire taxable year.[3] In such event, the citizen may generally exclude earned income from sources outside the United States in computing his gross income which is subject to tax. Three basic requisites must be established:

a. The taxpayer must prove that he is a bona fide resident of a foreign country or countries.

b. He must prove that his foreign residence extended over an uninterrupted period including an entire taxable year.

c. The earned income which he seeks to exclude may not represent amounts paid by the United States or any agency thereof.[4]

2. The second method by which a United States citizen living abroad can secure an exemption is to comply with the 510-day rule.[5] This rule was introduced by the Revenue Act of 1951, for the purpose of relieving the tax burden of American technicians who took jobs abroad and who could not qualify as bona fide residents of foreign countries. It was believed that the new law would assist our government's program of financial and technical assistance to underdeveloped countries. Public protest against the abuse of this exemption, however, caused Congress to amend the law in 1953.[6] The 510-day rule, generally speaking, provides for an exemption if a taxpayer can show that he lived in a foreign country for 510 days out of a period of 18 consecutive months. This limited exemption will be more fully explained in Section 7 of this Chapter.

3. The Requirement of Bona Fide Foreign Residence

In order to determine whether a citizen qualifies for the status of a bona fide resident of a foreign country, it is necessary to consider a great many evidentiary facts. The Regulations dispose of the problem of establishing criteria for determining residence in a deceptively simple manner.[7] They state that the same principles apply in determining the residence abroad of American citizens as apply in determining the country of residence of an alien.[8] A study of the Regulations covering the residence of aliens, however, does not do much to clarify the problem, since the rules set forth by the Commissioner are difficult to apply and in some cases inconsistent. One of the few fixed criteria is the duration of stay in the foreign country.[9]

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[3] 1954 IRC § 911(a)(1); 1939 IRC § 116(a)(1).

[4] However, see 1954 IRC § 912 (1939 IRC § 116(j)), exempting cost-of-living allowances paid to Government employees stationed abroad. In *Lief J. Sverdrup*, 14 T.C. 859 (1950) (Acq.), a partner's share of profits from a partnership contract with the United States was treated as income "paid by the United States." Payments by the United States to employees of a government contractor may constitute earned income. Rev. Rul. 54-483, 1954-2 C.B. 168. See Section 8 of this chapter for a discussion of what constitutes earned income.

[5] 1954 IRC § 911(a)(2); 1939 IRC § 116(a)(2).

[6] "Some individuals with large earnings have seized upon the provision as an inducement to go abroad to perform services, which were customarily performed at home, for the primary purpose of avoiding the Federal income taxes." Senate Finance Committee Report on amendment by Sec. 204 of the Technical Changes Act of 1953, P.L. 287, 83rd Cong., 1st Sess.

[7] Reg. 118, § 39.116-1.

[8] Reg. 118, § 39.211-2, 211-3, 211-4 and 211-5.

[9] Reg. 118, § 39.211-2.

4. Treasury Rulings on Establishing Foreign Residence

Complementing the Regulations, the Commissioner has issued several rulings dealing with specific cases. In one ruling[10] a citizen went to Canada as an employee on a war project, intending to stay for a period of about 17 months. He lived for the most part in "temporary quarters which he will in all probability abandon upon termination of his employment." The Commissioner ruled that the taxpayer was not a bona fide resident of Canada, but was merely a transient.

Another ruling[11] concerned the status of American citizens who, having established the status of bona fide residents of a foreign country, thereafter served in the American armed forces. Requirements of military service necessitated that they leave their country of foreign residence and, in some cases, spend prolonged periods of time in the United States. The Commissioner ruled that the foreign residence was only temporarily interrupted and that the exemption was applicable.

It should be noted that neither ruling indicates in detail the criteria for determining bona fide foreign residence.

5. Judicial Interpretation Concerning Foreign Residence

Many of the recent cases dealing with the question of bona fide residence in a foreign country have involved war workers employed in foreign countries during World War II. The majority of the cases have been decided against the taxpayer, although it was made clear that each particular factual pattern must be examined in order to determine whether bona fide residence abroad has actually been established.

In the *Swent* case,[12] the Court of Appeals for the Fourth Circuit placed great stress upon the fact that the taxpayer spent two-thirds of the year in the United States and held that the taxpayer was not a bona fide nonresident. The Court pointed out that although the taxpayer was domiciled in Mexico, he was not a bona fide resident of Mexico for income tax purposes.

The Fifth Circuit Court of Appeals, in the *Swenson* case,[13] held that a taxpayer who had contracted to work in Colombia for three years became a bona fide resident of that country, even though his domicile remained the United States. In the *Downs* and *Hoofnel* cases,[14] the Court of Appeals for the Ninth Circuit held that since the taxpayers were engaged in a war project and paid no British taxes, they did not acquire the status of bona fide residents of England. In the

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[10] I.T. 3642, 1944 C.B. 262.

[11] I.T. 3797, 1946-1 C.B. 99.

[12] *Commissioner* v. *Swent* (4 Cir. 1946), 155 F. 2d 513, 34 AFTR 1376. It should be noted that the applicable statutory provision for the years involved required a showing that the taxpayer was a "bona fide nonresident (sic) of the United States for more than six months during the taxable year."

[13] *Swenson* v. *Thomas* (5 Cir. 1947), 164 F. 2d 783, 36 AFTR 461.

[14] *Downs* v. *Commissioner* (9 Cir. 1948), 166 F. 2d 504, 36 AFTR 805, decided with *Hoofnel* v. *Commissioner*. The court made the interesting observation that a person may have two places of residence, citing *Matter of Newcomb's Estate*, 192 N.Y. 238, 250, 84 N.E. 950, 954 (1908).

Johnson,[15] *Love*[16] and *Chapin*[17] cases, the Tax Court refused to recognize war workers in foreign countries as bona fide residents of the foreign countries. The *Bouldin* case,[18] however, turned out differently. The taxpayer, although a war worker, was held to be a resident of Canada, since he had announced his intention of settling there permanently in order to alleviate a serious sinus condition.

Other recent cases reinforce the view that it is difficult to make a generalized and definitive statement of the criteria for determining bona fide residence in a foreign country. For example, some cases have inferred an intention to remain abroad permanently from the fact that the taxpayer was accompanied by his family. Yet in the *Seeley* case,[19] the Court of Appeals for the Second Circuit decided that a taxpayer establishing a "temporary home" in London was a bona fide resident of England, notwithstanding the fact that his wife was compelled to remain in the United States because of war conditions. Judge Learned Hand benignly pointed out, "Certainly it would not further the general purpose of the statute to induce Americans to take jobs abroad, if those were granted tax exemption who could take their wives, but those were not, who could not." In the *Rose* decision,[20] the taxpayer was held to be a resident of England, even though he paid no income tax to England, and made frequent trips to the United States. The Tax Court stressed the fact that the taxpayer moved with his family and personal effects and rented an apartment in London under a five-year lease. Furthermore, he became identified with the English way of life by such acts as joining English clubs (and resigning from American clubs) and opening charge accounts in London stores.

In the *Kyle* case,[21] the Court of Appeals for the Tenth Circuit, reversing the District Court, ruled that a pipe fitter employed by an oil refinery in Saudi Arabia was not a resident of that country because: (a) he intended to return to the United States after 18 months and purchase a farm; (b) his wife remained in the United States; (c) he paid no taxes to Saudi Arabia; (d) his passport imposed a time limitation; (e) he did not apply for naturalization; (f) he did not establish permanent living quarters; (g) he sent most of his earnings to the United States; (h) he did not identify himself with the customs or habits of Saudi Arabia; (i) he did not assimilate himself socially into his foreign environment; (j) his employment was for a brief and limited duration. This case, by stressing in detail the absence of evidence of bona fide residence abroad, provides an instructive illustration of the importance of minutiae in determining the question.

Perhaps the most interesting recent case in this field is *Fuller* v. *Hofferbert*.[22] In

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[15] *Arthur J. H. Johnson*, 7 T.C. 1040 (1946).

[16] *Ralph Love*, 8 T.C. 400 (1947).

[17] *Dudley A. Chapin*, 9 T.C. 142 (1947).

[18] *Charles F. Bouldin*, 8 T.C. 959 (1947) (Acq.).

[19] *Seeley* v. *Commissioner* (2 Cir. 1951), 186 F. 2d 541, 40 AFTR 100. Apropos the question of "double residence" (see footnote 12, above), the court said, "We do not say that it is never possible to have two independent 'residences' at the same time; but we do say that the statute here before us certainly did not contemplate such a possibility, for that would have defeated its purpose."

[20] *David E. Rose*, 16 T.C. 232 (1951) (Acq.).

[21] *Jones* v. *Kyle* (10 Cir. 1951), 190 F. 2d 353, 40 AFTR 1031.

[22] *Fuller* v. *Hofferbert* (6 Cir. 1953), 204 F. 2d 592, 43 AFTR 956. Some other recent

1943 the taxpayer was a 27-year-old employee of an engineering concern that had undertaken to supervise the construction of oil refineries in Soviet Russia under the terms of a lend-lease agreement. He was offered a position of great responsibility and high salary in order to induce him to go to Russia. Furthermore, as the Court pointed out, "the spirit of adventure . . . probably exceeded the other considerations."

The opinion of the Sixth Circuit Court of Appeals describes the arduous living conditions (such as temperatures ranging from 140° Fahrenheit in the summer to 40° below zero in the winter), the "atmosphere of fear and oppression," and the taxpayer's continued fascination with the challenge of his job. Mr. Fuller repeatedly and futilely tried to bring his wife over to Russia. In 1945, his wife's illness compelled the taxpayer to return to the United States, after an absence of two years.

The Court of Appeals, in reversing the District Court, held that Mr. Fuller was a bona fide resident of Soviet Russia in 1944. It stressed the magnitude and long duration of the construction projects for which the taxpayer was employed, his mastery of the Russian language, his friendships among the people, and his attempts to have his wife join him. The Court rejected the government's puritanical argument that a happily married man cannot establish a bona fide residence in a foreign country while his wife remains in the United States.

6. Summary of Factors Indicating Bona Fide Residence

Despite the inconsistencies and vagueness of the criteria applied in the regulations, rulings and decisions, there have emerged certain factual patterns which *tend* to show that the taxpayer has established bona fide residence abroad. It should always be borne in mind, however, that facts emphasized by one court are often minimized or completely rejected as irrelevant by another court.

The following are some factors which have been indicative of bona fide residence in a foreign country:

Presence in foreign country for many years
Few interruptions during period of presence in foreign country
Long term job in foreign country
Marriage to native of the foreign country
Purchase of foreign home
Long term lease of foreign home or apartment
Presence of family in foreign country
Transfer of possessions to foreign country
Permanent need for taxpayer's type of work in foreign country
Visa, passport and customs forms showing intention to reside abroad
Registration at U.S. consulate as foreign resident
Correspondence and statements to others supporting claim of residence abroad
Plans for future business operations in foreign country
Payment of foreign taxes
Mastery of foreign language

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cases of particular interest are *Leigh White*, 22 T.C. No. 76 (1954); *Fred H. Pierce*, 22 T.C. No. 62 (1954); *Burlin B. Hamer*, 22 T.C. No. 45 (1954); *Ernest R. Hertig*, 19 T.C. 109 (1952); *C. Francis Weeks*, 16 T.C. 248 (1951)(Acq.); *Herman F. Baehre*, 5 T.C. 236 (1950)(Acq.); *Carl H. Thorsell*, 13 T.C. 909 (1949); *Meals* v. *U.S.* (D.C., Calif. 1953), 110 F. Supp. 658, 43 AFTR 564.

Charge accounts in foreign stores
Joining of foreign clubs, churches, etc.
Subscriptions to foreign periodicals
Social and cultural acclimatization to foreign environment
Securing of foreign licenses and permits
Diminishing business and social ties in the United States

7. The 510-Day Rule

The "510-day rule"[23] permits an exclusion from gross income by a citizen of the United States who complies with the following requirements:

a. The income sought to be excluded must be "earned income" from sources outside the United States.[24]

b. The income sought to be excluded may not represent amounts paid by the United States or any agency thereof.[25]

c. The income sought to be excluded must be attributable to a period of 18 consecutive months in which the taxpayer was present in a foreign country or countries for at least 510 full days.[26] Time and place of payment are immaterial,[27] except insofar as the $20,000 annual exclusion limit may be reduced, as described below.

d. The exclusion for the taxable year may not exceed $20,000 if the 18-month period includes the entire taxable year. If only a portion of the taxable year is included within the 18-month period, the $20,000 ceiling will be proportionately reduced.[28]

If the tax return is due before the taxpayer can determine whether or not he has complied with the 510-day rule, he may file a return without regard to the exclusion and later apply for a refund after he has qualified under the Internal Revenue Code. However, he may not find it practical to pay the tax and then apply for a refund. In that event, he should follow the alternative procedure of applying for an extension of time in which to file his return. Such an extension may be granted for more than six months in the case of taxpayers who are abroad.[29]

In preparing his declaration of estimated tax, a taxpayer may eliminate income which he reasonably believes will be excluded from gross income.[30] Also, an employer may eliminate such income in determining how much to withhold from the employee's salary.[31]

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[23] The "510-day rule" is embodied in 1954 IRC § 911(a)(2) and Reg. 118, § 39.116-1(b).

[24] See Section 8 of this chapter for a discussion of what constitutes earned income.

[25] See footnote 4, above. See also *Lief J. Sverdrup*, 14 T.C. 859 (1950)(Acq.); I.T. 3679, 1944 C.B. 263; I.T. 3505, 1941-2 C.B. 72; I.T. 3259, 1939-1 C.B. 127.

[26] Reg. 118, § 39.116-1(b)(3) provides in effect that time spent in a foreign country prior to 1952 may be included in the 18 month period when determining income to be excluded in 1952.

[27] Reg. 118, § 39.116-1(a)(6); *Herman A. Kollmar* 4 T.C. 727 (1945)(Acq.); *Chidester* v. *U.S.* (Ct. Cls. 1949), 82 F. Supp. 322, 37 AFTR 1059. But see *Wood* v. *U.S.* (Ct. Cls. 1952), 104 F. Supp. 1020, 42 AFTR 90; *Crispin* v. *U.S.* (9 Cir. 1952), 200 F. 2d 99, 42 AFTR 925; *Flanagan Estate*, 18 T.C. 1241 (1952).

[28] Rev. Rul. 54-72, 1954 I.R.B. No. 9 (p. 11). The $20,000 limitation was introduced in the Technical Changes Bill of 1953, and is fully effective for taxable years ending after December 31, 1953. For taxable years ending before January 1, 1952 there was no limitation. A partial limitation was effective in the case of fiscal years beginning in 1952 and ending in 1953. Reg. 118, § 39.116-1(b)(2). See Rev. Rul. 55-497, 1955 IRB No. 32 (p. 10).

[29] Reg. 118, § 39.116-1(b)(4).

[30] Reg. 118, § 39.116-1(b)(5).

The taxpayer may count only "full days" in determining whether the time requirement has been satisfied.[32] A "full day" means the period from midnight to midnight, and not just any consecutive 24-hour period. Although you may not get credit for time spent en route to a foreign country, the term "foreign country" includes the air space over such country.[33] The time spent in foreign countries while working for the United States will count towards satisfaction of the 510-day requirement,[34] even though the income paid by the government is not excludable from gross income.

The 510-day requirement applies to *any* period of 18 consecutive months. The statute contemplates that the 18-month periods may overlap, and the regulations provide illustrations of this principle. For example, income earned on June 30, 1954 may be excluded because it falls within a qualified 18-month period running from February 1, 1953 to August 1, 1954. Income earned by the same taxpayer on August 31, 1954 may be similarly excluded because it falls within a qualified 18-month period running from January 1, 1954 to July 1, 1955.

8. What Kind of Income is Exempt?

If the taxpayer meets either the test of bona fide foreign residence, or complies with the requirements of the 510-day rule, he thereupon becomes entitled to exclude from gross income[35] (a) earned income (b) which is received from sources outside the United States, (c) which is not paid by the United States or any agency thereof, (d) and which is attributable to such period.

The Internal Revenue Code defines "earned income" as including (a) wages, (b) salaries, (c) professional fees, and (d) other amounts received as compensation for personal services actually rendered.[36] Salary paid by a corporation to a stockholder constitutes earned income only to the extent that it does not represent a distribution of earnings and profits rather than reasonable compensation for personal services actually rendered.[37]

The statute also provides that up to 30 per cent of the net profit of a trade or business may constitute earned income, where both personal services and capital are material income producing factors. The exact percentage to be applied will depend upon the facts in each individual case.[38]

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[31] 1954 IRC § 3401(a)(8); 1939 IRC § 1621(a)(8).

[32] Reg. 118, § 39.116-1(b)(10).

[33] Reg. 118, § 39.116-1(b)(7).

[34] Reg. 118, § 39.116-1(b)(10).

[35] 1954 IRC § 911; 1939 IRC § 116(a).

[36] 1954 IRC § 911(b); 1939 IRC § 116(a)(3). In *Frank L. Kluckholm*, 18 T.C. 892 (1952), the Tax Court held that the sale by a nonresident citizen of foreign rights to an article written while he was abroad does not give rise to earned income. Cf. *E. Phillips Oppenheim*, 31 B.T.A. 563 (1934). See also *Herman A. Kollmar*, 4 T.C. 727 (1945), holding that a fee received for effecting the sale of debentures in Germany constituted earned income. I.R.-Mim. No. 71, 1952-2 C.B. 170 deals with pension and profit sharing plan payments to nonresident citizens. See also Rev. Rul. 55-294, 1955 IRB No. 20 (p. 16).

[37] See *Beaumont* v. *Helvering* (C.A. of D.C., 1934), 73 F. 2d 110, 14 AFTR 559; *Harold F. Jones*, 6 T.C. 412 (1946).

[38] Reg. 118, § 39.116-1(a)(5). Gains on the sale of non-business personal property are not exempt. Rev. Rul. 54-105, 1954 I.R.B. No. 12 (p. 4).

If the taxpayer is engaged in a professional occupation, such as a lawyer or a doctor, the entire amount received as professional fees constitutes earned income. If he employs assistants, his fees will still be earned income, provided the patients or clients are those of the taxpayer and regard him as responsible for the services performed.[39]

9. Disallowance of Deductions Attributable to Excluded Income

If a taxpayer is entitled to exclude earned income from foreign sources, a portion of his deductions is disallowed. This is true whether the exclusion is the result of bona fide residence in a foreign country, or compliance with the 510-day rule. The Code provides that such a taxpayer shall not be allowed any deductions (other than for personal exemptions) properly allocable to or chargeable against amounts excluded from gross income.[40]

In the *Hempel* case,[41] the taxpayer sought a deduction for the amount by which excluded foreign earned income was exceeded by deductions allocable to such income. The Tax Court rejected the taxpayer's argument that Section 911 is a relief provision to be applied only at the election of the taxpayer.

If the allocable deduction is paid in a taxable year following the excludable period, is the deduction nevertheless allowable? The Tax Court ruled in the *Heffelfinger* case[42] that the taxpayer was not entitled to deduct Canadian income taxes paid in 1941, since the taxes were imposed on excluded Canadian income which was earned in 1939 and 1940.

10. Miscellaneous Considerations

The objective of tax planning for any taxpayer is generally the minimization of his total tax burden without undue sacrifice of other objectives. In order to analyze the tax status of a citizen living abroad, it is necessary not only to examine the Internal Revenue Code, but also the following subjects:

a. **Currency restrictions** imposed by the foreign country in which the taxpayer is living or intends to live should be investigated. It would also be helpful to inquire about the likelihood of future tightening or relaxation of such restrictions. If blocked currency is involved, the applicable tax rules should be explored.[43]

b. **Tax treaties and conventions,** in effect or pending, must be studied in order to determine their effect upon the tax burden.[44]

c. **Tax laws of foreign countries** will have to be studied, including exemptions, exclusions, deductions, rates, capital gains, etc. Taxes imposed by political subdivisions such as states, cantons, provinces and municipalities may affect the situation. It is also necessary to determine whether the foreign country allows a credit or deduction for United States income taxes.

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[39] Reg. 118, § 39.116-1(a)(4).

[40] 1954 IRC § 911(a); 1939 IRC § 116(a)(1), (2). The allocation is determined in accordance with 1954 IRC §§ 861-864 and Reg. 118, § 39.119. See Rev. Rul. 55-191, 1955 IRB No. 14 (p. 18).

[41] *Frieda Hempel,* par. 47,183 Prentice-Hall Memorandum T.C. (1947).

[42] *George W. P. Heffelfinger,* 5 T.C. 985 (1945).

[43] The special tax rules for blocked currency and foreign exchange are described elsewhere in this book.

[44] Tax treaties with the following countries are now in effect: Australia, Belgium, Canada, Denmark, Finland, France, Greece, Ireland, Japan, Netherlands, New Zealand, Norway, Sweden, Switzerland, Union of South Africa, United Kingdom, and Western Germany.

What is the best way to qualify for the exclusion? Insofar as the tax laws of the United States are concerned, this chapter has described the working of Section 911, which is the most important section of the Internal Revenue Code dealing with American citizens living abroad. As has been previously indicated, it may make a considerable difference whether one qualifies for the exclusion by compliance with the test of bona fide foreign residence, or by use of the 510-day rule.

The chief advantage of the 510-day rule is the elimination of the tricky problem of proving bona fide residence in a foreign country. One further advantage is that the taxpayer may start qualifying for the exclusion in the middle of a taxable year, even though the period of foreign residence does not include an entire taxable year. The obvious advantage of the foreign resident status is that there is no ceiling on excludable earned income, as contrasted with the $20,000 ceiling applicable to the 510-day status.

The taxpayer who decides to live abroad should try to comply with both tests if possible. By compliance with the 510-day rule, he is assured of the $20,000 exclusion. Compliance with the bona fide residence test will entitle him to an unlimited exclusion and may also make it possible for him to spend more vacation time in the United States after he has established his status.

Filing returns for Americans living abroad. Special procedural rules apply to United States citizens who are living abroad. If the taxpayer is residing or traveling outside the country, he is entitled to an automatic three-month extension for filing his income tax return.[45] However, interest will be due from the 15th day of the third month following the close of the taxable year. A further extension may be secured when the amount of excludable income is not yet determinable.[46] Declaration of estimated tax[47] and withholding[48] by an employer may both reflect reasonable assumptions as to income which will be excludable by virtue of Section 911.

Special rule for U.S. possessions. Special elective rules apply if the taxpayer is a United States citizen who is engaged in trade or business within a possession of the United States.[49] Income from foreign sources is exempt from tax if 50 per cent of the gross income for three years (or an applicable shorter period) is derived from the active conduct of the trade or business and 80 per cent of the gross income for the same period is derived from any sources within the possession. However, all income which is received in the United States must be included in gross income.[50] The allowable deductions are determined in the same manner as for a nonresident alien engaged in trade or business within the United States.[51] Only one $600 exemption is allowed if a taxpayer elects to take advantage of this special rule.[52]

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[45] Reg. 118, § 39.53-3(a). A taxpayer whose address is outside the continental United States is entitled to an additional 60 days in which to file a Tax Court petition.

[46] 1954 IRC § 6081(a); 1954 IRC § 6161(a); 1939 IRC § 53(a)(2); Reg. 118, §39.53-2, 39.116(a)(7).

[47] Reg. 118, § 39.116-1(a)(8). Extensions of more than six months are allowed under 1954 IRC § 6081(a) and 1954 IRC § 6161(a); 1939 IRC § 58(e).

[48] 1954 IRC § 3401(a)(8); 1939 IRC § 1621(a)(8).

[49] 1954 IRC § 931; 1939 IRC § 251. Possessions of the United States include the Panama Canal Zone, Guam, Samoa, Wake and Midway. U.S. military bases in foreign countries are not possessions. I.T. 3914, 1951-1 C.B. 4046.

A taxpayer who is a citizen of a possession, but not otherwise a citizen of the United States, is entitled to exclude all income from foreign sources if he is not a resident of the United States.[53]

Special rule for Puerto Rico. A United States citizen who is a bona fide resident of Puerto Rico for the full taxable year may exclude income derived from sources within Puerto Rico.[54] The only requirement as to the nature of the income is that it may not be compensation paid by the United States or one of its agencies. Deductions allocable to the excluded income are disallowed.

Conclusion. There has been much justified criticism levelled at the use of foreign tax "havens" by American citizens seeking to avoid payment of their just share of the nation's tax burden. Recent changes in the law have sought to limit the availability of flagrantly unfair devices, without destroying the worthwhile objectives of the earlier legislation. This chapter shall have fulfilled its purpose if it has explained the methods currently provided by our tax law for securing the special tax benefits granted to American citizens who live and work in foreign countries.

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[50] Payments mailed from the possession and delivered in the United States must be included in gross income. *Fred M. Harden*, 44 B.T.A. 961 (1941). However, payments constructively received in the foreign country may be excluded. I.T. 3804, 1946-1 C.B. 151.

[51] 1954 IRC § 931(d)(1), (f); 1939 IRC § 251(e)(1), (g).

[52] 1954 IRC § 931(e); 1939 IRC § 251(f).

[53] 1954 IRC § 932; 1939 IRC § 252.

[54] 1954 IRC § 933; 1939 IRC § 116(1).

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How Aliens Are Taxed in the United States

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The tax problems arising from the business and personal affairs of foreign taxpayers are so infinitely varied and complex that it would be foolhardy to assume that direct and simple answers can be found by a mere perusal of this chapter. Careful study must be made of tax treaties, currency restrictions, tax law and practice in foreign countries, and a host of other topics which would ordinarily bear upon the complete solution of any particular problem.

1. Points to Consider

Resident and nonresident aliens are treated differently under our tax laws. Furthermore, within the nonresident alien group there are various classifications, each with its own tax incidents. This chapter concerns itself with the following problems:

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2. Who Are Resident Alien Individuals?

A resident alien is a person, not a citizen of the United States, who, by overt acts, has indicated an intention, as of a given date, to reside here permanently. An alien by reason of his alienage is theoretically presumed to be a nonresident alien. The Regulations list the types of evidence which may overcome this presumption.[1] These include:

a. Proof that the alien has filed a declaration of his intention to become a citizen.

b. The filing of Form 1078 or its equivalent with a withholding agent (this is the certificate of an alien claiming residence in the United States required to be executed in order to preclude further withholding).

c. Proof of overt acts indicating an intention to acquire residence here.

Probably the simplest evidence of residence is an immigration visa that does not limit the stay in the United States to a definite period.[2] However, persons here under temporary visas may, nevertheless, be considered resident aliens by reason of exceptional circumstances, including, in the case of stateless persons, the mere fact that they have no other place to go.[3]

3. How Resident Aliens Are Taxed

A resident alien has substantially the same income tax liabilities as a citizen.[4] He is taxable on income from all sources, including sources from without the United States as well as on gains on the sale or exchange of capital assets.

However, there are several differences:

a. He is not entitled to the exclusion of earned income from sources without the United States. This privilege is available only to a citizen under the circumstances set forth in the statute.[5]

b. The credit for foreign taxes paid by a resident alien is limited to the extent that the country of which he is a citizen allows a similar credit to citizens of the United States.[6] It is also available with respect to taxes paid or accrued to any possession of the United States.

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[1] Reg. 118, § 39.211-4. Note that this regulation provides for a more stringent test of residence in the case of an alien departing for his native country.

[2] Reg. 118, § 39.211-2; I.T. 3386, 1940-1 C.B. 66.

[3] Mim. 5883, 1945 C.B. 244; *Molnar* v. *Commissioner* (2 Cir. 1946), 156 F. 2d 924, 35 AFTR 54. Some of the cases dealing with the problem include *Florica Constantinescu*, 11 T.C. 36 (1948) (Acq.); *Rolf Jamvold*, 11 T.C. 122 (1948) (Acq.); *Commissioner* v. *Nubar* (4 Cir. 1950), 185 F. 2d 584, 39 AFTR 1311, cert. denied 341 U.S. 925 (1951); *Commissioner* v. *Patino* (4 Cir. 1950), 186 F. 2d 962, 40 AFTR 132; *Ceska Cooper*, 15 T.C. 757 (1950); *Marsman* v. *Commissioner* (4 Cir. 1953), 205 F. 2d 335, 44 AFTR 53. A foreign student whose course of study requires at least two years of study in the United States is a resident alien. Rev. Rul. 54-87, 1954 I.R.B. No. 10 (p. 9). But see Rev. Rul. 54-485, 1954-2 C.B. 244.

[4] Reg. 118, § 39.211-1.

[5] 1954 IRC § 911; 1939 IRC § 116(a).

[6] 1954 IRC § 901(b)(3); 1939 IRC § 131(a)(3). If a resident alien, a citizen of Holland, pays income taxes to France, for example, is the foreign tax credit available, or is the statute confined to a tax payment only to the country of nationality? See *Max Freudmann, et al.*, 10 T.C. 775 (1948) where the literal interpretation of the statute was not considered. It would appear that the credit is available under the circumstances stated, particularly if Holland allows American citizens residing there a credit for taxes paid to France. Compare the present language of the statute with § 222(a)(3) of the Revenue Act of 1918 which read as follows:

> "(3) In the case of an alien resident of the United States who is a citizen or subject of a foreign country, the amount of any such taxes paid during the taxable year to such country, upon income derived from sources therein, if such country, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country;"

See also *Chas. W. Bowring*, 27 B.T.A. 449 (1932).

c. A resident alien, unlike a citizen, may exclude from gross income wages, fees, or salaries paid to him by a foreign government or an international organization, to the extent that the statutory provisions are otherwise satisfied.[7]

d. Aliens, although resident within the United States, may not take advantage of Sections 931 and 932 of the Internal Revenue Code, exempting income from United States possessions for specified citizen taxpayers and domestic corporations.

e. A departing alien must procure from the Treasury Department a certificate that he has complied with the federal income tax laws.[8]

f. Tax conventions between the United States and foreign countries produce disparities between the taxation of resident aliens and American citizens.[9]

A resident alien, like a citizen, may enjoy the benefits of the split income provisions of the Internal Revenue Code, but, like a citizen, no joint return may be made if either spouse at any time during the taxable year is a nonresident alien.[10]

Similarly a resident alien, like a citizen, may not take as a dependent one who is a nonresident alien, unless the dependent is resident in the Canal Zone, Panama or a country contiguous to the United States.[11]

The estate of a resident alien is subject to the same estate tax liability as is a citizen's and is entitled to the same credits and deductions, including the marital deduction.[12] However, the test for determining residence for estate tax purposes is more rigid than the test used for income tax purposes. Thus, a person deemed a resident here with respect to income tax liability may still be a nonresident for estate tax purposes.[13]

The wills of noncitizens require careful analysis in order to assure maximum estate tax benefits (if American residence is probable), but not at the sacrifice of personal objectives.[14]

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[7] 1954 IRC § 893; 1939 IRC § 116(h). Hence, resident aliens who are United Nations employees pay no tax on their salaries, whereas resident citizens, similarly employed, are taxable (although their tax liability may be assumed by the employer).

[8] 1954 IRC § 6851(d); 1939 IRC § 146(e). The Code prescribes a 25 per cent penalty for violation. 1954 IRC § 6658; 1939 IRC § 146(f). Holders of diplomatic passports are exempt from this requirement. Rev. Rul. 54-551, 1954-2 C.B. 234.

[9] For example, Article VI of the tax convention with Canada provides that pensions and life annuities paid by the Canadian government to Canadian citizens residing in the United States are exempt from United States taxation.

[10] 1954 IRC § 6013(a)(1); 1939 IRC § 51(b)(2).

[11] IRC § 25(b)(3). 1954 IRC § 152(b)(3); 1939 IRC § 25(b)(3). Note that the new Code liberalizes these provisions with respect to dependents living in the Canal Zone, Panama, and the Philippines.

[12] No attempt is made here to comment upon the various problems that may arise upon the death of resident aliens, including double taxation and the protection afforded by treaties.

[13] *Estate of J. W. Nienhuys*, 17 T.C. 1149 (1952); *Estate of Anthony H. G. Fokker*, 10 T.C. 1225 (1948). See Reg. 105, § 81.5, where a person is held to be a resident who at the time of his death had his domicile in the United States. A domicile is acquired "in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom." See also Reg. 108, § 86.4 for the definition of residence for gift tax purposes. In the *Nienhuys* case, the Court stated: "Neither do we regard with any significance the decedent's filing of resident income tax returns. Residence has a different meaning in the income tax provisions of the Code than it has in those relating to estate tax."

[14] An examination of our death tax conventions with the United Kingdom as well as those with Canada, France, Norway, Ireland, Greece, Japan, Switzerland, Finland, Australia, and the Union of South Africa may be in order.

4. Who Are Nonresident Alien Individuals?

There are three classes of nonresident alien individuals:

a. Those not engaged in trade or business within the United States and deriving not more than $15,400 gross amount of fixed or determinable annual or periodical income from sources within the United States plus net capital gains;

b. Those in the same category but whose gross amount of such income exceeds $15,400;

c. Those engaged in trade or business within the United States.

The basic question with respect to all three is the meaning of the term "nonresident alien."

The concept of a nonresident alien individual for federal income tax purposes is a negative one. The Regulations for the Internal Revenue Code of 1939[15] state that one whose residence is not within the United States and who is not a citizen is a nonresident alien individual.[16] An alien, physically present here, who is not ". . . a mere transient or sojourner is a resident . . ." But mere physical presence unaccompanied by ambulatory tendencies may not be enough to spell out residence, for the Regulations also state: "An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances."

The exigencies of war have further confused a confusing concept. Thus, in referring to the "exceptional circumstances" that may lessen the effect of a temporary visa on the status of an alien, the Commissioner has stated[17] that the type of visa issued is but one of the elements determining the classification of an alien. When many aliens received temporary visas or visitors' permits during the war, their desire was to get out of war-torn countries ". . . under any conditions and under any passport or visa so long as they reached the United States."[18]

As stated above, an alien, by reason of his alienage, is presumed to be a nonresident alien.[19] It would thus appear that the status of a resident is not very readily acknowledged by the Commissioner. For income tax purposes, an alien may wish to forego the status of a resident in a given year in order to escape tax on income received from sources outside the United States. However, the Commissioner has not hesitated to impose the status of a resident on a protesting alien who wished to maintain the status of nonresident.[20] The Commissioner has ruled that an alien who obtains a reentry permit before leaving the United States will ordinarily continue to be regarded as a resident until his permit expires.[21]

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[15] Reg. 118, § 39.211-2.

[16] The term includes a nonresident alien fiduciary.

[17] Mim. 5883, 1945 C.B. 244.

[18] See *Ferenc Molnar* (2 Cir. 1946), 156 F. 2d 924, 35 AFTR 54.

[19] Reg. 118, § 39.311-4.

[20] *Walter J. Baer*, 6 T.C. 1195 (1946); *L. E. L. Thomas*, 33 B.T.A. 725 (1935); *John H. Chapman*, 9 T.C. 619 (1947); *Florica Constantinescu*, 11 T.C. 36 (1948)(Acq.); *Rolf Jamvold*, 11 T.C. 122 (1948)(Acq.); *Commissioner* v. *Patino* (4 Cir. 1950), 186 F. 2d 962, 40 AFTR 132.

[21] I.T. 4057, 1951-2 C.B. 93.

5. How Nonresident Aliens Are Taxed

a. Nonresident alien individuals not engaged in trade or business within the United States at any time during the taxable year and deriving in the taxable year not more than $15,400 gross amount of fixed or determinable annual or periodical income from sources within the United States, plus net capital gains.[22]

"Engaged in trade or business." Neither the Code nor the Regulations contain an overall definition of the term "engaged in trade or business within the United States." Performance of personal services within the United States at any time during the taxable year is included in the term.[23]

Services performed for a nonresident alien employer do not come within the term if the employer is not engaged in trade or business within the United States and the employee is here less than 90 days during the taxable year and receives compensation not exceeding $3,000.[24] The Internal Revenue Code of 1954 extended this provision to services performed for a foreign office of a domestic corporation.

Maintenance of an office or place of business in the United States is no longer listed as a test in determining whether a nonresident alien is engaged in trade or business in the United States.[25]

Merely effecting transactions in stocks, securities, or commodities through a resident broker, commission agent, or custodian does not constitute engaging in trade or business within the United States.[26] The commodities transactions referred to are those customarily consummated on an organized commodity exchange, for example, a grain or cotton futures market. However, nonresident aliens who visit the United States may be taxed on net capital gains on the transactions just mentioned.[27]

The maintenance of an office or place of business test still applies to nonresident aliens who transact business on a commodity exchange. They are not considered to be engaged in a trade or business in the United States if they do not maintain an office or place of business in the United States through which transactions in commodities are effected.[28]

Income subject to tax. Nonresident alien individuals not engaged in trade or business within the United States are subject to tax only on amounts:

Constituting net capital gains computed in accordance with Section 871 of the Internal Revenue Code, or

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[22] Reg. 118, § 39.211-7.

[23] 1954 IRC § 871(c); 1939 IRC § 211(b). See *Joseph Van Der Elst*, par. 53,363 Prentice-Hall Memorandum T.C. (1953).

[24] *Ibid.*; 1954 IRC § 861(a)(3) excludes such income as income from sources within the United States. See 1939 IRC § 119(a)(3).

[25] Revenue Act of 1942, § 160(d). An isolated transaction does not constitute "doing business." *Jorge Pasquel*, par. 54,002 Prentice-Hall Memorandum T.C. (1954).

[26] 1954 IRC § 871(c); 1939 IRC § 211(b); but see *Adda* v. *Commissioner* (4 Cir. 1948), 171 F. 2d 457, 37 AFTR 654 and Rev. Rul. 55-282, 1955 IRB No. 19 (p. 39). See also *Chang Hsaio Liang*, 23 T.C. No. 130 (1955).

[27] 1954 IRC § 871(a)(2); 1939 IRC § 211(a)(1)(B).

[28] 1954 IRC § 871(c); 1939 IRC § 211(b). Extensive transactions effected through an American agent may constitute being engaged in business in the United States. *Adda* v. *Commissioner* (4 Cir. 1948), 171 F. 2d 457, 37 AFTR 654; *Jan C. Lewenhaupt* 20 T.C. 151 (1953), aff'd (9 Cir. 1955), 221 F. 2d 227.

From sources within the United States,[29] which are fixed or determinable annual or periodical gains, profits and income.[30]

A nonresident alien individual who is temporarily present within the United States, but not engaged in trade or business here, is taxed on capital gains from sources within the United States.[31] If he has been present in the United States for less than 90 days during the taxable year, only the net capital gains effected during his presence will be taxed. However, if he has been present in the United States for 90 days or more during the taxable year, all of his net capital gains from United States sources will be taxed, whether or not effected during his presence in this country. The amount of net capital gains which are thus taxable is included in determining whether the $15,400 limitation has been exceeded.

The statute[32] lists the types of interest taxable to nonresident alien individuals. Besides interest on bonds and notes, it is necessary to include interest on open accounts, condemnation awards, judgments, tax refunds,[33] and obligations of the United States, any territory or the District of Columbia, and individual or corporate residents. Interest on deposits with banks is excluded.[34]

Interest on obligations of resident alien individuals, resident foreign corporations, or domestic corporations may not be taxable, if less than 20 per cent of the debtor's gross income is derived from sources within the United States for the three-year period ending with the close of the debtor's taxable year which precedes the year of payment.[35]

The source of the income of the declaring corporation determines the includability in gross income of dividends. Dividends are not includible if received from a domestic corporation which has derived less than 20 per cent of its gross income from sources within the United States for the three years ending with the close of the taxable year preceding the year of the declaration of the dividend.[36]

Dividends are not includible if received from a foreign corporation which derived less than 50 per cent of its gross income for the preceding three years from sources within the United States. The dividends are includible in the same proportion as income from sources within the United States bears to gross income.[37]

Compensation for labor or personal services performed within the United States is ordinarily includible (absent special treaty arrangements). If the taxpayer was temporarily present in the United States for 90 days or less, however, Section 861(a)(3) permits the exclusion of up to $3,000 received from a nonresident alien, foreign partnership, or foreign corporation not engaged in trade or business within the United States, or from a foreign branch of a domestic corporation. The place where the contract was made or the place of payment is immaterial.

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[29] 1954 IRC § 861; 1939 IRC § 119.

[30] 1954 IRC § 871(a)(1); 1939 IRC § 211(a)(1)(A); *Commissioner* v. *Wodehouse*, 337 U.S. 369, 69 Sup. Ct. 1120, 37 AFTR 1363 (1949).

[31] 1954 IRC § 871(a)(2); 1939 IRC § 211(a)(1)(B).

[32] 1954 IRC § 861(a)(1); 1939 IRC § 119(a)(1).

[33] *Motty Eitingon*, 27 B.T.A. 1341 (1933); *Waldorf Astor*, 31 B.T.A. 1009 (1935); G.C.M. 21968, 1940-1 C.B. 67; Reg. 118 § 39.119-2.

[34] Provided the nonresident alien individual is not engaged in business within the United States. 1954 IRC § 861(a)(1)(A); 1939 IRC § 119(a)(1)(A).

[35] 1954 IRC § 861(a)(1)(B); 1939 IRC § 119(a)(1)(B).

[36] 1954 IRC § 861(a)(2)(A); 1939 IRC § 119(a)(2)(A).

[37] 1954 IRC § 861(a)(2)(B); 1939 IRC § 119(a)(2)(B).

The statute does not specifically mention royalties as a type of income from sources within the United States that a nonresident alien individual not engaged in trade or business within the United States must include in gross income. The Regulations, however, require the inclusion of royalties.[38] The courts have not hesitated to require the inclusion of royalties, even where they were paid in a lump sum,[39] or made to resemble a sale rather than a license.[40]

The statute does specifically mention rents. Rents (and royalties) considered here are those received from property or an interest in property located in the United States.[41] Does the receipt of rents constitute one as engaged in trade or business within the United States? Rental of real property by a nonresident alien individual has been ruled not to constitute of itself a trade or business, nor is there a trade or business, according to the Tax Court, where rental is merely incidental to collection of dividends and interest on bonds.[42] But the same court has held that ownership of rental property constitutes a trade or business within the United States where the rented property is a substantial portion of a nonresident alien's American property.[43]

The Internal Revenue Code of 1954 added the following types of income to the tax base of nonresident alien individuals not engaged in trade or business in the United States:

a. Distributions from an employees' trust which are treated as capital gains under Section 402(a)(2);

b. Gain from the disposal of timber, coal or iron which is treated as capital gain under Section 631(b) and (c);

c. Gain from the transfer of a patent which is treated as capital gain under Section 1235.

Other fixed or determinable annual or periodical income is also included in gross income of the class under discussion. If the income is to be paid in definitely predetermined amounts it is *fixed*. If there is a basis of calculation by which the amount to be paid may be ascertained, it is *determinable*.[44] Annual payments are not necessary if the payments are made periodically.[45]

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[38] Reg. 118, § 39.211-7(a); royalties are also referred to as constituting fixed or determinable annual or periodic income subject to withholding. Reg. 118 § 39.143-2.

[39] *Commissioner* v. *Wodehouse*, footnote 30, above. *Rohmer* v. *Commissioner* (2 Cir. 1946), 153 F. 2d 61, 34 AFTR 826, cert. den. 328 U.S. 862 (1946); *Sanchez* v. *Commissioner* (2 Cir. 1947), 162 F. 2d 58, 35 AFTR 1417; Note, *Yale Law Journal*, 1945, Vol. 54, page 879. Note also the sequels in *Wodehouse* v. *Commissioner* (2 Cir. 1949), 177 F. 2d 881, 38 AFTR 998; *Wodehouse* v. *Commissioner* (4 Cir. 1950), 178 F. 2d 987, 38 AFTR 1248; *Sax Rohmer*, 14 T.C. 1467 (1950). See also *Misbourne Pictures Ltd.* v. *Johnson* (2 Cir. 1951), 189 F. 2d 774, 40 AFTR 772.

[40] *Bloch* v. *U.S.* (2 Cir. 1952), 200 F. 2d 63, 42 AFTR 909.

[41] 1954 IRC § 861(a)(4); 1939 IRC § 119(a)(4). See Rev. Rul. 55-17, 1955 IRB No. 2 (p. 17).

[42] G.C.M. 18835, 1937-2 C.B. 141. *Elizabeth L. M. Barbour* (1944), par. 44,073 Prentice-Hall Memorandum T.C.; see also *Evelyn M. L. Neill*, 46 B.T.A. 197 (1942).

[43] *Estate of Frances S. Yerburgh*, par. 45,382 Prentice-Hall Memorandum T.C. (1945). The Commissioner seems to have accepted the doctrine that the rental of real property is a trade or business, *Leland Hazard*, 7 T.C. 372 (1946)Acq. The applicability of this concept to nonresident aliens renting real property would appear logical, unless a separate rule is reserved for nonresident aliens; see *Rohmer* v. *Commissioner* (2 Cir. 1946), 153 F. 2d 61, 34 AFTR 826, and Judge Frank's language in distinguishing *Goldsmith* v. *Commissioner* (2 Cir. 1944), 143 F. 2d 466, 32 AFTR 1005.

[44] Reg. 118, § 39.143-2.

[45] 1954 IRC § 871(a).

Computation of tax and withholding. A nonresident alien individual not engaged in trade or business within the United States, whose gross income is not more than $15,400, is taxable on *gross income.* He gets no allowance for personal exemptions or deductions. For example, an author who receives royalties through his American agent (the agent deducting his commission and forwarding the balance) is taxable on the amount received by the agent.[46]

Nonresident alien individuals in this category pay 30 per cent of gross income from sources within the United States of the type discussed above,[47] including capital gains. The law requires payors[48] of fixed or determinable annual or periodical income to nonresident alien individuals to deduct and withhold 30 per cent of the income.[49] The requirement applies whether or not the nonresident alien is engaged in trade or business within the United States. If the withholding agent fails to collect and deduct the tax he becomes personally liable for any unpaid taxes resulting therefrom.[50]

Those who must withhold the tax include lessees, mortgagors, fiduciaries, and employers having control, receipt, custody, disposal, or payment of a nonresident individual's income described as fixed or determinable annual or periodical income. Tax must be withheld on income paid to a nonresident alien fiduciary, even though the beneficiaries are United States citizens or residents.[51]

The payor who deposits a nonresident individual's royalties in the latter's American bank must withhold tax.[52] No withholding is required on the distribution to a nonresident alien individual of captial gains of a trust.[53] Lessees must withhold on rental payments made directly to nonresident alien individuals, even though the rental of real property may be considered a trade or business.[54]

Tax should be withheld on payments by a publisher to the American agent of a nonresident alien author. The agent is required to withhold if the publisher fails to do so.[55]

An exempt pension trust must withhold tax on distribution of taxable benefits to employees.[56]

Returns. Form 1042, the withholding return, must be filed by the withholding agent by March 15. The tax return of a nonresident alien individual is due on June 15. Form 1040NB is required from nonresident alien individuals not engaged in trade or business within the United States with income of no more than $15,400, whose tax liability is not fully satisfied at the source. This return should be made by or for him no later than the 15th day of the sixth month following the close of his tax year.

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[46] *Rohmer* v. *Commissioner* (2 Cir. 1946), 153 F. 2d 61, 34 AFTR 826.

[47] 1954 IRC § 871(a)(1); 1939 IRC § 211(a)(1)(A). Treaties fix varying rates of tax and exempt certain types of income from gross income. 1954 IRC § 894; 1939 IRC § 22(b)(7).

[48] 1954 IRC § 1441; 1939 IRC § 143(b).

[49] See the exceptions set forth in 1954 IRC § 1441 and in Reg. 118, § 39.143-1.

[50] 1954 IRC § 1461; 1939 IRC § 143(c); *McGrath* v. *Dravo Corporation* (3 Cir. 1950), 183 F. 2d 709, 40 AFTR 8. See Rev. Rul. 54-584, 1954-2 C.B. 212.

[51] Reg. 118, § 39.143-1. An interesting distinction between no withholding when a nonresident alien *sells* warrants to subscribe to stock, and withholding when he *exercises* the warrants, is made in special rulings dated Jan. 15, 1948 and April 29, 1949 respectively.

[52] I.T. 2624, XI-1 C.B. 122; I.T. 3940, 1949-1 C.B. 113, with respect to withholding tax on interest regardless of where payable or where the collateral is located; see also *A. C. Monk & Co. Inc.,* 10 T.C. 77 (1948).

[53] I.T. 3495, 1941-2 C.B. 195; see also I.T. 3781, 1946-1 C.B. 119, exempting distributions in corporate reorganizations from withholding, although taxable to recipients under 1939 IRC § 112(c)(2).

[54] G.C.M. 18835, 1937-2 C.B. 141.

[55] I.T. 2624, XI-1 C.B. 122.

[56] 1954 IRC § 1441(b). See I.R.-Mim. No. 71, 1952-2 C.B. 170.

A departing alien is required by Section 6851(d) to obtain a certificate from the Treasury Department stating that he has complied with all his income tax obligations. All aliens, including resident aliens, must satisfy this requirement.[57]

b. Nonresident alien individuals not engaged in trade or business within the United States at any time during the taxable year and deriving in the taxable year more than $15,400 gross amount of fixed or determinable annual or periodical income from sources within the United States, plus net capital gains.

The tax law is intended to tax nonresident alien individuals at a rate that is not less than that paid by residents. (An exception to this intention occurs in the cases where nonresident aliens receive the benefits of tax treaties.) A nonresident alien individual not engaged in trade or business in the United States with an income of $15,400 pays (at 30 per cent) almost the same tax as an unmarried resident whose net income is $15,400.

A nonresident alien individual in the classification discussed here (one whose gross income exceeds $15,400) is taxed on the same items of income as the individual in the group previously discussed. The tax rate in this group, however, is similar to that paid by residents.[58]

Deductions allocable to the income from U.S. sources are allowed. Deductions for contributions to domestic corporations, community chests and other specific recipients listed in the statute are permitted. The deductions are subject to the limitations of Section 170.[59]

Not more than one $600 exemption is allowed unless the alien is a resident of a contiguous country.[60] A joint return may not be filed.

The tax computed as outlined above cannot be less than 30 per cent of the gross income that falls into the taxable categories discussed in the previous section of this chapter.[61] The withholding provisions previously discussed apply to the gross income of the nonresident alien individuals in this group as well.

Form 1040NB-a must be filed by members of this group with the Director of Internal Revenue, Baltimore, Md., not later than the 15th day of the sixth month following the close of the taxable year.[62] Loss of credits or deductions otherwise available may result from a failure to file.[63]

c. Nonresident alien individuals who at any time during the taxable year are engaged in trade or business within the United States.[64]

Gross income from sources within the United States[65] less the deductions and credits allowed by law[66] determines the net income subject to tax. In this group, all gross income from sources within the United States is included.[67] Thus, there would be included gains from the sale of personal or real property in the United States, including stock, securities, and commodities transactions. Also included is interest on bank deposits.

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[57] For a detailed explanation of departing alien procedures see Reg. 118, § 39.146-1(b) and (c).

[58] 1954 IRC § 871(b); 1939 IRC § 211(c).

[59] 1954 IRC § 873(c); 1939 IRC § 213(c).

[60] 1954 IRC § 873(d); 1939 IRC § 214.

[61] 1954 IRC § 871(b)(3); 1939 IRC § 211(c)(3).

[62] 1954 IRC § 6072(c); 1939 IRC § 217.

[63] 1954 IRC § 874(a); 1939 IRC § 215(a); Reg. 118, § 39.215-1; *Nicholas Roerich* (D.C. Cir. 1940), 115 F. 2d 39, 25 AFTR 913, cert. den. 312 U.S. 700 (1941).

[64] This group includes a nonresident alien individual member of a partnership that is engaged in trade or business within the United States; 1954 IRC § 875; 1939 IRC § 219.

[65] 1954 IRC § 872(a); 1939 IRC § 212(a).

Gross income from transactions that cannot be specifically identified as being either from sources within or without the United States may be treated as being partly from sources within and partly without the United States.[68]

A nonresident alien in this group is entitled to the same deductions from the income he derived from sources within the United States as are available to residents. However, he is not entitled to the 10% optional standard deduction. Business expenses, interest, taxes, losses in trade or business, bad debts, depreciation, and depletion are all deductible.

Losses incurred in a transaction entered into for profit (not compensated for by insurance) are allowable (although not connected with the alien's trade or business). But the deduction is limited to the extent that profits—if there had been profits—would have been taxable as income from sources within the United States.[69] Casualty losses on property located in the United States are deductible. Contributions (to the extent limited by Section 170) are deductible. But they must be made to domestic corporations, community chests, funds, or foundations created in the United States or to a vocational rehabilitation fund.[70]

Except in the case of a resident of Canada or Mexico, the personal exemption is limited to $600.[71] The credit for foreign taxes paid is not available to a nonresident alien engaged in trade or business in the United States.[72]

Nonresident aliens in this group are subject to the same withholding provisions on the same type of income as nonresident aliens not engaged in trade or business in the United States.[73] But no withholding is required on payments to a partnership engaged in trade or business simply because a partner is a nonresident alien.[74]

Nonresident alien individuals engaged in trade or business in the United States pay the same rate of tax on their taxable income as do residents.[75]

Form 1040B must be filed by nonresident aliens in this group not later than the 15th day of the sixth month following the close of the taxable year. The return should be filed with the Director of Internal Revenue, Baltimore, Md. Loss of the benefit of deductions and credits otherwise available[76] and the invoking of penalty provisions[77] may result from failure to file.

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[66] 1954 IRC § 861(b); 1939 IRC § 119(b); Reg. 118, § 39.211-7(c).

[67] 1954 IRC § 861; 1939 IRC § 119; this does not include items exempt by statute or treaty. For compensation received from foreign governments see 1954 IRC § 893; 1939 IRC § 116(h). See *John H. Chapman,* 9 T.C. 619 (1947); *Louis Vial,* 15 T.C. 403 (1950)(Acq.).

[68] 1954 IRC § 863; 1939 IRC § 119(e); Reg. 111, § 39.119(e)-1, 2, 3.

[69] Reg. 118, § 39.213-1(b); see *Virginia R. Carranza,* 11 T.C. 224 (1948).

[70] 1954 IRC § 873(c); 1939 IRC § 213(b).

[71] 1954 IRC § 873(d); 1939 IRC § 214. Aliens residing in Canada or Mexico are entitled to the same exemptions as U.S. citizens.

[72] 1954 IRC § 874(c); 1939 IRC § 216.

[73] Reg. 118, § 39.143-1(a).

[74] 1954 IRC § 1441(a); 1939 IRC § 143(b); I.T. 3233, 1938-2 C.B. 192.

[75] 1954 IRC § 871(c); 1939 IRC § 211(b).

[76] 1954 IRC § 874(a); 1939 IRC § 215(a). See T.D. 6096, 1954-2 C.B. 69, 74, amending Reg. 118, § 39.217-1(a).

[77] Reg. 118, § 39.217-1.

Careful study is required when there is a shift of status, from resident to nonresident or vice versa. For example, a cash basis resident alien reporting on the calendar year may receive income from sources outside the United States in August. In December of the same year his status changes to that of a nonresident alien. The income he received in August is taxable even though he became a nonresident in the same year.[78] If the change in the example given had been from nonresident to resident, the August income would be excluded.

6. Advantages and Disadvantages of Being a Resident Alien Rather Than a Nonresident Alien

Since an alien taxpayer may, if he is a resident alien, use substantially the same credits, exemptions, and deductions as a citizen, the status of "resident alien" may not only be desirable for political and personal reasons, but for income tax benefits as well. On the other hand, the status may result in increased tax liability when compared with that which would under certain circumstances be payable by a nonresident alien.

Consider the case of a married alien taxpayer whose sole income from all sources consists of dividends of $8,000 paid by a domestic corporation (specific treaty arrangements will be disregarded for the purpose of this example). If he is a resident alien, his income tax liability would be about $1,240.

If the same taxpayer were held to be a nonresident alien for the same tax period, he would be subject to a flat tax of 30 per cent or $2,400.

If during the course of the taxable year the alien should have incurred any substantial casualty loss, paid interest or medical expenses, made charitable contributions, or sustained capital losses, his tax liability as a resident would have been reduced still further or possibly eliminated. In his status as a nonresident alien, the various deductions and exemptions are unavailable, since he is taxed on gross income.

If the alien taxpayer receives income from sources outside the United States during the taxable year, his status as a resident would require its inclusion in gross income.

If the individual's status is that of a nonresident, his income tax liability in the United States is fixed not only as to the rate of tax, but as to the source of income. He is taxable only on income from sources within the United States.

Thus, assume a married resident alien has the following sources of income:

Dividends from United States corporations	$ 8,000
Dividends from foreign corporations	20,000
Income from foreign trusts	22,000
Gross income from all sources	$50,000
Estimated United States income tax	19,000

If a nonresident alien should enjoy the same income, his United States income tax liability would be limited to $2,400 (30 per cent of $8,000).

Mention has been made of the type of visa as possibly determinative of the alien's status as a resident. If it is assumed, all other things being equal, that the day of entry into this country on an immigrant's visa fixes the date when an alien becomes a resident alien for income tax purposes, the timing of that event may then be important. Assume that "A," a citizen of Colombia, has worked outside the United States for an American employer, pursuant to an arrangement whereby he receives a percentage of profits on goods sold by his employer here. On November 1, 1954 his earned but unpaid commissions amounted to $100,000. On that day he arrived in the United States under a temporary visa, which was renewed from time to time. He then re-entered the country under a permanent visa. The day after his re-entry, he received the $100,000.

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[78] *John C. Lee,* 6 B.T.A. 1005 (1927).

Under these circumstances, he is taxable on the full amount received for a tax of possibly $50,000. Yet, if the money had been sent to him while he was still in Colombia or possibly paid to him while he was under a temporary visa (absent of course, any clear overt act from which residence could have been otherwise inferred during the period), then no United States tax would have been payable. Thus a clear understanding of the income tax effect on the change of his status might have resulted in substantial tax savings.[79]

The enormous expansion of business dealings between the United States and foreign countries will continue to make the taxation of aliens a lively as well as a difficult topic. To keep abreast of new developments which may affect aliens, the tax practitioner must give careful attention to treaties, as well as to the more common sources of tax law, such as statutes, court decisions, regulations, and rulings.

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[79] *J. A. C. Steur*, 7 T.C. 1075 (1946). It is also important to note that an alien who has once acquired residence in the United States is presumed to have retained his status until he abandons it and actually departs from the United States. Reg. 118, § 39.211-5.

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Tax Savings in Filing Joint Returns

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1. Points to Consider

If you have the opportunity to choose between filing a joint return or separate returns, you will want to consider:

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- The Nature of Joint Returns 2
  - What Is a "Joint Return" . . . . . a
  - The Benefits of "Income-Splitting" . . . . . b
- Advantages in Joint Returns 3
  - Offsetting Incomes and Losses . . . . . a
  - Deductions for Contributions . . . . . b
  - Deductions for Gambling Losses c
  - Long Term Compensation and Back Pay . . . . . d
  - Credits for Dependents . . . . . e
- Disadvantages of Joint Returns 4
  - Deduction for Medical Expenses . . . . . a
  - Deduction for Net Operating Losses . . . . . b
  - Capital Losses c
  - Liability for Tax Payment . . . . . d
  - Self Employment Tax . . . . . e

If you have decided that it is more advantageous for you to file a joint return, you must consider:

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  - Marital Status Required . . . . . a
  - Effect of Death of a Spouse . . . . . b
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  - Joint return is a binding election . . . . . a
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Liability for tax payments .... b
Effect on election of final return c
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2. What is a Joint Return

a. General nature. The Internal Revenue Code provides that a husband and wife may make a single return jointly, and the tax is then computed on the aggregate income.[1] The Regulations require that the gross income and adjusted gross income of the spouses be computed in an aggregate amount, and the deductions allowed and the taxable income be likewise computed on an aggregate basis.[2] This means that the losses of one spouse will generally offset the gains of the other.

Therefore, in a joint return, deductions which are limited to a percentage of adjusted gross income (such as charitable contributions) are figured on the aggregate adjusted gross income, and capital losses are combined and allowed only to the extent of the combined capital gains (plus taxable income or $1000, whichever is smaller). Consequently, although there are two taxpayers on a joint return, there is reported only one taxable income.[3]

b. Income splitting. Although there has always been the possibility of tax savings where one spouse had losses which would reduce the gains of the other, there is now a similar possibility where both have gains to report. In such situations, taxpayers domiciled in community property states have had the advantage in that the spouses could split the community income, and by filing separate returns obtain the benefits of using the lower surtax brackets twice. The Revenue Act of 1948, in effect, extended this tax benefit to all married taxpayers through the medium of "income-splitting" in the tax computation on a joint return. For years beginning after 1947, the tax on a joint return is twice what it would be if the net income and credits against net income were reduced by one-half.[4] A substantial savings may result by reason of the graduated rates of surtax. For example, on a taxable income of $40,000 on a separate return, the tax is $19,740 (for

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[1] 1954 IRC § 6013(a); 1939 IRC § 51(b).

[2] Reg. 118, § 39.51(1)(b).

[3] *Helvering* v. *Janney*, 311 U.S. 189. *Taft* v. *Helvering*, 311 U.S. 195 (1940).

[4] 1954 IRC § 2; 1939 IRC § 12(d).

1954). On a joint return, it would be twice the tax on $20,000 ($7,260) or $14,520, representing a savings of $5,220, or about 26 per cent of the tax on a separate return. (For a more complete illustration, see Regulations 118, Sec. 39.12-3.)

The Internal Revenue Service has prepared a schedule for simplified computation of tax on a joint return, which eliminates the need for computing the tax on one-half, and multiplying the result by 2. However, an adjustment is necessary where partially tax exempt interest is involved.[5]

3. Comparative Advantages of Joint Returns

a. The most obvious advantage occurs where one spouse has losses, which may be offset against the income of the other, as the combined net income is thereby reduced. A similar benefit is obtained, although to a lesser degree, where one spouse has no income or deductions, or a net income less than $600. While this does not reduce the combined net income, the benefit arises from the acquisition of a $600 credit for the spouse.

And, as noted above, a further advantage is available in all cases, even where both spouses have large incomes, through the use of "Income Splitting" in the tax computation. The advantage tends to disappear as the incomes of the spouses approach a state of equality, where twice the tax on ½ the combined income is the same as the sum of the taxes on the separate incomes.

Therefore, on joint returns, the tax is generally less than on separate returns if the combined taxable income exceeds $2,000 (the first surtax bracket) or one spouse has some gross income but less than $600 of net income.

b. The allowable deduction for contributions[6] may be increased where a spouse who has no adjusted gross income has made contributions, and the other spouse has not used the 20 per cent (or 30 per cent) maximum amount (computed on his separate adjusted gross income). This will be so, except where the first spouse has other deductions from adjusted gross income in excess of 5 times the separate contributions (where the 20 per cent limitation is applicable).

Similarly, a benefit is obtainable where both spouses have adjusted gross incomes and one spouse has exceeded the separate limitations but the other has not.[7]

c. Deductions for gambling losses are allowable only to the extent of gains from gambling; but on a joint return, losses of one spouse may be offset against gains by the other, as the losses and gains are aggregated.[8]

d. A recent Court decision recognized a possible advantage in a joint return where 1939 IRC Section 107 (compensation for 36 months or more, or back pay) was involved.[9] The husband and wife included in their joint return a lump sum compensation received in that year, earned by the husband in prior years when he had filed separate returns, and then pro-rated it over their respective separate returns for the period during which the husband earned it. The Internal Revenue Code of 1954 (Sec. 1304) prohibits this procedure.

Another recent decision, in a community property law state, points out the difficulties in trying to apply 1939 IRC Section 107(a) on separate returns for the year compensation was received, where joint returns had been filed in the years to which the income was attributable.[10]

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[5] Rev. Rul. 17; 1953-4.

[6] 1954 IRC § 170; 1939 IRC § 23(o).

[7] Reg. 118, § 39.23(o)-1.

[8] Reg. 118, § 39.23(h)-1.

[9] *Hofferbert* v. *Marshall*, 200 F. 2d 648 (4 Cir. 1952), 42 AFTR 1014.

e. In addition to the advantages in computing net income, a further benefit may be available in an increased exemption allowance for dependents. While the Regulations prescribe certain relationships that must exist between the taxpayer and the dependent (on a separate return), the prescribed relationship is not necessarily required between the dependent and the spouse furnishing the support if a joint return is filed, so long as the relationship exists with respect to either spouse.[11]

4. Comparative Disadvantages of Joint Returns

a. As noted in 2a, deductions which are limited to a percentage of adjusted gross income are figured on the aggregate adjusted gross income. While this may result in an advantage on joint returns in connection with contributions, the result may be otherwise in the case of the deduction for extraordinary medical expenses.

Expenses for medical care of the taxpayer, spouse and dependents are deductible to the extent that they exceed 3 per cent of the adjusted gross income.[12] Consequently, where the joint return results in an increased adjusted gross income, the unallowable portion of the deduction is correspondingly increased.

Separate returns would, therefore, be more advantageous especially where one spouse has high medical expenses in proportion to income, while the other has no medical expenses or much less than 3 per cent of income. Of course if either spouse has attained the age of 65, the expenses of both spouses (but not of the dependents) are not reduced by this 3 per cent adjustment.

On the other hand, the upper limit on the deduction may be increased on a joint return depending on the total of exemptions, as it is only $5000 on a single or married person's separate return, but $10,000 on a joint return (based upon $2500 for each exemption, other than for blindness and old age). Consequently, it will often be necessary to make alternative trial computations to determine whether the advantage lies with the joint or separate returns.

Where a taxpayer's daughter filed a joint return with her husband, but received more than half her support from the taxpayer, she qualified as a dependent of the taxpayer, who may therefore claim a deduction for medical expenses paid for the daughter, although no exemption may be claimed for her as a dependent.[13]

b. The use or creation of a net operating loss deduction may often be accomplished more advantageously by filing separate returns. This would occur where one spouse has a large net operating loss which can be carried back to a preceding year where there was a large income reaching into the higher tax brackets, thereby producing a large refund. In this case, separate returns are preferable in the current year, as a joint return might use some of the loss as an offset against a small income of the other spouse, in a low tax bracket. This would also apply to a possible carry forward, although the effect might be more difficult to compute accurately.[14]

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[10] *Ford* v. *Commissioner* (9 Cir. 1954), 217 F. 2d 886.

[11] Reg. 118, § 39.25-2(e).

[12] 1954 IRC § 213; 1939 IRC § 23(x).

[13] I.T. 4034, 1950-2 C.B. 28.

[14] Reg. 118, § 39.122-4(e); *James H. Cunningham,* 20 T.C. 65.

Where a current joint return follows prior joint returns, or current separate returns follow prior separate returns, the computations are made in the usual manner. But where a current joint return follows prior separate returns, the carryover losses of both spouses may be used. Other situations may require adjustments and further computations.

The special five-year $50,000 limitation on certain losses in trade or business is applied separately to the spouses on a joint return, even though they are partners. Rev. Rul. 54-178, 1954-1 C.B. 128.

c. Where there is a net capital loss by each spouse, separate returns would allow the use against ordinary income up to $1000 on each return, whereas on a joint return the combined allowance is limited to $1000. This would tend to become more important as the incomes of the spouses approach a state of equality. In close cases, only a trial computation would be reliable as a basis for choice of joint or separate returns. Consideration would also have to be given to possible advantages in the 5 year carryover of net capital losses rather than immediate use against capital gains of the other spouse.[15]

Similarly, in connection with the alternative tax rate of 25 per cent on net long term capital gains, a computation should be made when the joint taxable income exceeds $36,000.

Furthermore, if one spouse has a capital loss, and the other has a long term capital gain, separate returns might produce a better result, if one can use the loss (up to $1000, of course) against ordinary income, while the other is limited to the alternative tax at the effective rate of 25 per cent. Also, in some instances, separate returns might allow a carryover of the capital loss of one spouse as preferable to the current reduction of a long term capital gain of the other spouse, on which the maximum tax is limited.

The capital loss carryovers shown in separate returns for prior years can be applied in full in a joint return for the current year. Where separate returns are filed after joint returns, the net capital losses on the prior joint returns are allocated to the current separate returns on the basis of their individual net capital losses in the preceding years.

d. While the joint return will usually result in a lesser tax than the total on separate returns, the advantage may be offset by the fact that the tax liability on a joint return is joint and several. Consequently, the Government may collect the entire tax from the spouse having little or no income to report. The District Director of Internal Revenue is not obliged to apportion the liability between the spouses. This also applies to interest and penalties, even though all of the income is that of only one of the spouses and the other had no fraudulent interest.[16]

Also, where refunds are made on a joint return, they are made to the taxpayers in joint names, without regard to the fact that one may have had no taxable income included in the original return.

These factors could be important where one spouse has died leaving an insolvent estate, or the spouses have separated, before the total tax liabilities have been paid. In one case the Government had released one of the joint obligors and was permitted to collect the balance from the other.[16a]

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[15] Reg. 118, § 39.117(e)-1(c).

[16] *Myrna S. Howell,* 10 T.C. 859 (1948), affd., 175 F. 2d 240 (6 Cir. 1949).

[16a] *U.S.* v. *Wainer,* 108 F. Supp. 386 (1952).

However, the payment by one spouse of the entire tax is not considered a taxable gift to the other spouse who had taxable income included in the return.[17] This furnishes an opportunity for one spouse to increase the estate of the other, without gift tax.

e. Likewise, for the purpose of self employment taxes on Schedule C of Form 1040, although "income splitting" is not available, the tax liability is joint and several.[18]

The tax on self employment income is computed on separate schedule C SE showing the self employment income of each spouse, but the aggregate tax becomes part of the liability on the joint return. If one spouse has net self employment income of less than $400, it is not subject to this special tax, but must be included on the joint return for computation of income tax.

5. Who May File a Joint Return

a. The privilege of filing a joint return is restricted to spouses who occupied a married status on the last day of the taxable year, or on the date of death of one of the spouses during the taxable year.

It is no longer necessary, as under prior law, that each spouse have some income or deductions, nor that they be living together at any time.[19] A marital status is deemed to exist so long as the spouses are not legally separated under a court decree of divorce or of separate maintenance.[20] This is determined under state law, so that where a divorcee was married legally in a state prior to the expiration of a waiting period stipulated in the divorce decree of another state, the marital status was recognized.[21]

Parties named in a California interlocutory decree of divorce are not considered married.[22] But parties who obtained an interlocutory decree of divorce in Utah, although legally separated, were considered husband and wife and entitled to file a joint return.[23]

Where the spouses are not living together, there may be a practical impediment to filing in view of the necessity for mutual consent of the parties as indicated by the requirement for both signatures (see Section 8(e) below), or the reluctance to disclose to each other the amounts or sources of income on the return.

b. Where one spouse has died during the taxable year, the survivor may file a joint return provided he or she did not remarry during the year. However, the surviving spouse may be eligible to file a joint return with his new spouse for that year.

It should also be noted that, under certain conditions, a surviving spouse who has not remarried may obtain "income-splitting" benefits for two years after his spouse's death.[23a]

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[17] E. T. 21, 1948-2 C.B. 156.

[18] Reg. 118, § 39.482-1(b).

[19] 1954 IRC § 6013(a); 1939 IRC § 51(b)(1).

[20] Reg. 118, § 39.25-2(f).

[21] Rev. Rul. 29; 1953-6.

[22] I.T. 3942, 1949-1 C.B. 69.

[23] *Marriner S. Eccles,* 19 T.C. 1049 (1953), affd. (4 Cir. 1954) 208 F. 2d 796. The Internal Revenue Service refuses to follow this decision. Rev. Rul. 55-178, 1955 IRB, 13 (p. 31).

[23a] 1954 IRC § 2.

c. In view of the special methods for taxing nonresident aliens, a joint return may not be filed if either spouse had such status at any time during the taxable year.[24]

6. When and How the Election is Made

a. The election to file a joint return is available for each taxable year regardless of the procedure in a preceding year. Although the election is binding for each year, a return filed before the due date may be replaced by another filed on or before the due date, in which event the election on the earlier return may be changed on the later return. After the due date, however, no change may be made in the election for that year.

The extension of time until June 15th, allowed by Reg. 118 Sec. 39.53-3(e) to U.S. citizens residing or traveling abroad permits a joint return to be filed by that date, even though one spouse has previously filed a separate return for that year.[25]

b. The election to file a joint return is made on the return itself, by appropriate entries and answers to questions, and signature by both spouses.

c. In the case of the death of one spouse or both spouses, during a taxable year, the joint return may be made only by the executor or administrator for the decedent, except that a surviving spouse may make such a joint return if no executor or administrator is appointed before the due date of the return. However, the executor or administrator thereafter appointed may disaffirm the joint return within 1 year after its due date, in which case it is deemed to be the separate return of the survivor, and the estate is relieved from the joint liability.

The executor might agree not to disaffirm if he received adequate assurance of indemnification as to liability for taxes and penalties. The disaffirmance by the executor or administrator is effected by his filing a separate return for the decedent with respect to that taxable year. It should be noted that the provisions as to delinquent returns and delinquency in tax payment may apply to such separate return.[26]

If a joint return is made for the decedent and surviving spouse, a request for prompt assessment by the decedent's personal representative does not shorten the period of limitation or assessment as to the survivor,[27] after eliminating the items applicable to the decedent.[28]

7. What Tax Forms May be Used

a. A joint return may always be filed on the long form (1040), but the short form may be used only if the combined adjusted gross income is less than $5000.

The optional form (1040A) may be used if the combined gross income meets the usual requirements of less than $5000 total, and from sources limited to wages, dividends and interest, with not over $100 aggregate of dividends, interest and wages on which no tax has been withheld. The Director figures the tax both ways: as a joint return and as separate returns, and assesses the lower tax liability.[29]

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[24] 1954 IRC § 6013(a); 1939 IRC § 51(b)(2).

[25] I.T. 3946, 1949-1 C.B. 81.

[26] Reg. 118, § 39.51-1(b)(ii).

[27] G.C.M. 13592, XIII-2 C.B. 174 (1934).

[28] 1954 IRC § 6013(a)(3); 1939 IRC § 51(b)(4).

b. The items of income and deductions of the spouses are combined before entry, except that separate figures are required on compensation for services, and income from business or profession for income tax (Schedule C) and for self employment tax (Schedule SE).

As noted above, percentage limitations on deductions apply to the combined adjusted gross income with respect to contributions and extraordinary medical expenses. Likewise, the standard deduction is limited to the lesser of 10 per cent of combined adjusted gross income, or $1000.

c. Where the standard deduction is not taken, a credit for normal tax (3 per cent) is allowed on the amount of partially tax exempt interest includable in the return. As to the full exemption of interest received on Treasury bonds issued prior to March 1, 1941, the amount of interest on $5000 principal amount may be claimed by each spouse who owns such bonds, or a possible combined exemption on $10,000 of principal.

8. How to Fill In the Form

a. As noted above, husband and wife may file a joint return on form 1040A, provided their combined gross incomes are within the limitations as to amount and source. If so used, item 4 of the return must show the income of each in accordance with state law.

If the combined income exceeds the $5000 limit, the taxpayers may still be eligible to file separate returns on Form 1040A, provided that the individual gross income is within the limitations as to amount and source.

However, this privilege of separate returns is not available if spouses are domiciled in a community property state, in which case they must use Form 1040 if they desire to file separate returns.

Deductions are not itemized on Form 1040A, but a standard deduction is allowed by the Director in computing the tax. Consequently, a husband and wife, otherwise eligible to file separate returns, may not use this form if either itemizes deductions, but both must use Form 1040 (long form) for such purpose.

It might also be noted that Form 1040A may not be used in many other situations, such as where a return is for a fiscal year, or not on the cash basis, or payments have been made on estimated tax, or there is liability for the special tax on self-employment income.

b. The short form 1040 (which consists of only the first sheet of the return) may be used for a joint return, if the combined adjusted gross income is less than $5000. Spouses may also file separate returns on the short form if their separate incomes qualify. However, as in the case of Form 1040A, if either spouse itemizes deductions, both must use Form 1040 (long form).

It may be noted, by contrast with Form 1040A, that Form 1040 (short form) is available for taxpayers on the cash or the accrual basis, and on a calendar year or a fiscal year. It is likewise available for a short period due to death of a taxpayer. But the short form may not be used in some instances, such as where the taxpayer is a non-resident alien, or files for a short period because of a change in his accounting period.

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[29] Reg. 118, § 39.400-1.

c. The regular long form (1040) is, of course, available for use by all taxpayers, and must be used in any case where adjusted gross income is $5000 or more, or non-business deductions are claimed ("itemized").

On a joint return (Form 1040) the standard deduction is the usual amount of 10 per cent of the adjusted gross income, but not exceeding $1000. Where the spouses file separate returns, the limitation is only $500 on each return. Furthermore, the standard deduction is not available at all to one spouse, if the other claims itemized (non-business) deductions.[30]

As noted, Form 1040 must be used for separate returns of spouses domiciled in a community property state (California, Louisiana, Nevada, Texas and 4 other western states). Such returns must each show one-half of the combined community income. Other details may vary among those states.

d. The exemptions allowed on a joint return are usually the combined exemptions that would be allowed on separate returns of the spouses. An amount of $600 is allowed for each spouse, plus $600 for blindness of each spouse, plus $600 for attainment of age 65 by each spouse. All such exemptions are allowable even though one spouse has died during the year.[31]

As noted previously, the allowance of $600 for each qualified dependent is broadened on a joint return, in that a required relationship may exist as to either spouse, regardless of which spouse furnished the chief support.[32] The decedent's credits for dependents are determined as of the date of death.

On the other hand, where a married person files a separate return, he may claim all of the personal exemptions for his spouse, but only if she had no gross income and is not the dependent of another taxpayer, and he may not claim her dependents.

The right to the exemption is not affected by the fact that the spouse had tax-exempt income.[33] A wife is never considered a "dependent" of a spouse for income tax purposes. It should be noted, however, that when a married person is claimed as a dependent of another person, the married person's exemptions for old age and blindness may not be taken.

e. A joint return must be signed by both spouses or their agents. One spouse, if duly authorized, may sign as agent for the other spouse. Authority may be shown on Form 936 or in a letter attached to the return. Both names should also be given in full in the heading of the return.

In case of a joint return, a power of attorney must be signed by both spouses, or by one of them who is duly authorized by the other, for use before the Internal Revenue Service (Conference & Practice Requirements). It is important to exercise care in completing and signing the return and powers of attorney.

Where a husband filed a return which was not signed by his spouse, it was held not to be a joint return, despite the Commissioner's attempt to "waive" the requirement for the wife's signature. The Treasury Regulation was held to be as binding on the Government as on the taxpayer.[34] On a return, signed only by the husband, the wife was held liable for deficiencies and penalties.[35] But in a similar situation, where the wife had no income, it was held not to be a joint return.[36]

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[30] 1954 IRC § 142(a); 1939 IRC § 23(aa)(4).

[31] Reg. 118, § 39.25-2(d).

[32] Reg. 118, § 39.25-2(e).

[33] I.T. 3741, 1945 C.B. 124.

f. On a joint return, the credit for taxes paid to a foreign country or U.S. possession is computed on the aggregate amount, and the limitations are applied to aggregates of net income.[37]

9. Spouses With Different Accounting Periods or Methods

a. In order to file a joint return, both spouses must have taxable years that began on the same day. Each spouse's prior reporting period continues, as the marriage of a taxpayer, whether in a community property state or in any other state, does not affect the continuity with which the taxpayer has filed tax returns.[38]

If it is necessary for one to make a change to meet this requirement, it is necessary to apply to the Commissioner for permission, on Form 1128, at least 60 days prior to the close of the fractional part of a year required to effect the change. Permission will usually be granted for this purpose so long as no other reason appears sufficient for denying such permission.[39] But a joint return may not be filed for a taxable year of either spouse which is such a fractional year.

b. A husband and wife who employ different accounting methods may file a joint return, aggregating their gross incomes and deductions, if their respective accounting methods clearly or accurately reflect their income.[40]

c. Under the Regulations governing the inspection of returns filed under the Internal Revenue Code, a joint return is open to inspection by either spouse, or his or her attorney in fact, or the representative of a deceased spouse, or, in the discretion of the Commissioner, by any heir, next of kin or beneficiary of the deceased spouse.[41]

d. If a joint return has been filed, the Commissioner may send either a joint or separate notice of deficiency, unless he has been notified by either spouse that a separate residence has been established. If so notified, a duplicate original notice must be sent to each spouse at his or her last known address.[42]

A waiver of the statute of limitations signed by the wife may not be effective as to the husband's joint return.[43] Similarly, a request for prompt assessment by a representative of a deceased party on a joint return may not be effective as to the survivor.[44]

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[34] *McCord* v. *Granger*, 201 F. 2d 103 (3 Cir. 1952).

[35] *W. L. & Stella H. Kann*, 18 T.C. 1032 (1952), affd. (3 Cir. 1954) 210 F. 2d 247.

[36] *Virginia M. Wilkins*, 19 T.C. 752 (1953), (A).

[37] Reg. 118, § 39.131(a)-1(e).

[38] *Irene Nunnery Theriot*, 15 T.C. 912 (1950), affd. 197 F. 2d 13 (5 Cir. 1952), *cert. den.*, 73 S. Ct. 167 (1952).

[39] Reg. 118, § 39.46-1.

[40] G.C.M. 25812, 1948-2 C.B. 54.

[41] T.D. 4929, 1939-2 C.B. 91; Rev. Rul. 54-379, 1954-2 C.B. 121.

[42] 1954 IRC § 6212(b)(2); Reg. § 301.6212-1.

[43] *Harry Ekdall*, 18 B.T.A. 1230.

[44] G.C.M. 13592, XIII-2 C.B. 174 (1934).

10. Amending Prior Years' Returns

a. Spouses who file a joint return for a taxable year may not file amended separate returns for that year after the due date of the return, except where an executor files a separate return for a decedent after disaffirming a joint return filed by the survivor.

b. Under a recent change in the law, however, any spouses who have filed separate returns for the taxable year 1951 or later may file an amended joint return for that year after the due date of the return.[45] Such amended return must be filed within 3 years of the original due date of the return, and only if there is payment in full of the amount due on the joint return.

In case of such change, the taxpayers are still bound by any other elections made in their separate returns as to income, deductions or credits, where such elections would have been irrevocable if the joint return had not been made. Also, a change to a joint return after the death of a spouse may be made only by his executor or administrator.

Where the tax on the joint return exceeds the aggregate of the tax on the separate returns, negligence or fraud penalties may be imposed upon such excess, if applicable, and the time for additional assessment of deficiencies includes one year after filing the joint return. However, the filing of the joint return does not extend the applicable period for obtaining any refund, nor does it avoid prosecution for fraud on the separate returns.

11. Declaration of Estimated Tax

a. In the case of a husband and wife, whether or not they are living together, a joint declaration of estimated tax may be made if the gross income of either spouse requires a declaration. If the gross income of each spouse requires declarations, they may elect to file joint or separate declarations.[46] As in the case of final returns, no joint return may be made if either spouse is a non-resident alien, if the couple is legally separated or divorced, or if the spouses have different taxable years. No joint declaration may be made after the death of a spouse.

A joint declaration, if not made by an agent, must be signed by both spouses. If one spouse signs as agent for the other, he must attach evidence of his authority to do so.

b. As in the case of the final income tax return, the liability of the spouses is joint and several on a joint declaration of estimated tax.[47]

c. The election to file joint or separate declarations of estimated tax does not affect the right to elect either joint or separate returns for the final return of income for the same taxable year.[48]

The spouses may treat their aggregate payments on a joint declaration of estimated tax as the payments of either of them, or divide them in any proportions if they file separate final returns.[49]

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[45] 1954 IRC § 6013(b); 1939 IRC § 51(g).

[46] Reg. 118, § 39.58(c)(1)(a).

[47] Reg. 118, § 39.58(c)(1)(c).

[48] IRC § 6013(a).

d. If, after a joint declaration, one spouse dies, no further payments are required from the estate. The survivor will still be liable for the remaining instalments unless he files an amended separate return. If the surviving spouse believes that a joint final return will be filed for that year, he may compute his separate return of estimated tax as if a joint declaration were being filed. The payments on the joint declaration may be divided in any way between the decedent and the surviving spouse if they file separate returns.

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[49] IRC § 6015(b).

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Y

Year, fiscal, 28, 33-34, 41-42, 263
Young, Milton, 1568-1590

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